# FEDERAL RESERVE'S FIRST MONETARY POLICY REPORT FOR 1982

## HEARINGS

BEFORE THE

## COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

NINETY-SEVENTH CONGRESS

SECOND SESSION

ON

OVERSIGHT ON THE MONETARY POLICY REPORT TO CONGRESS PURSUANT TO THE FULL EMPLOYMENT AND BALANCED GROWTH ACT OF 1978

FEBRUARY 11 AND 25, 1982

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

[97–48]

U.S. GOVERNMENT PRINTING OFFICE

91-262 O WASHINGTON : 1982

S241-14

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# FEDERAL RESERVE'S FIRST MONETARY POLICY REPORT FOR 1982

THURSDAY, FEBRUARY 11, 1982

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
*Washington, D.C.*

The committee met at 10 a.m., in room 5302, Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn, Schmitt, Lugar, Proxmire, Cranston, Riegle, Sarbanes, and Dixon.

## OPENING STATEMENT OF CHAIRMAN GARN

The CHAIRMAN. The committee will come to order.

Chairman Volcker, we are pleased to have you with us today. I recognize it is difficult under the law requiring you to report every 6 months on monetary policy to have to go before the House one day and the Senate the next day and we will reverse that process so next time you will be before the Senate first. I recognize it is difficult for you from the standpoint that you have the same message and have to do a replay 2 days in a row. I certainly would not ask you to go through your full statement again as you did yesterday but summarize as you see fit, and then be responsive to questions from the committee.

Before we start, I would like to make a few opening remarks and offer a little bit of background. Over a period of several years, far before I became chairman of the Banking Committee, we have had the opportunity to privately discuss monetary and fiscal policy many times across this table. As you know, as interest rates have been high for some time and we have had a great deal of problems in the economy, the normal tendency, particularly in Congress, both in the House and the Senate, has been to look for scapegoats, to look everyplace but within to find the source of the problems.

I have been a persistent commentator and defender of the Fed in many ways, not that we always agreed on various aspects of monetary policy. But I've said from this bench dozens of times that you can't separate monetary and fiscal policy. That they had to go hand in hand. And that the Fed had a very difficult time when fiscal policy was out of control, which I believe it has been for many, many years, through several administrations, through many different Congresses.

I think the proof of that is a $1 trillion debt and $115 billion of interest on the national debt. Congress is continually unwilling to

get its fiscal house in order. I have also stated many, many times that I felt that that was, without doubt, at least in this Senator's opinion, the major cause of inflation—not the only cause, but the major cause, and the major source of high interest rates.

Yet we have seen a perfect example. After the August recess we came back in and I was faced with I don't know how many—12, 13, 14 bills, all kinds of speeches, prairie popularism rhetoric like I could not believe. After Members had been home during August talking about high interest rates and had heard from their constituents, the convenient scapegoat was the Fed. Let's dump it all on the Fed. Let's not let the people of this country know we had anything to do with it in Congress. Let's just say it's all the Fed's fault through its monetary policy. There were all sorts of bills to restructure the Fed. Let's put a farmer, let's put a businessman, let's put a one-eyed, one-toed South African diving bird on the board at the Fed. If we had passed all those bills, every one that has come before this committee, I don't think the legislation would have had one bit of impact on the economy or on interest rates.

It may make people feel good and compel Senators and Congressmen to put in bills and say we're doing something about the Fed and we're going to solve the problems. Sometimes I feel like combining all of them and passing them so we can show the world that those kind of solutions aren't going to help the problem.

Well, that's past history and I just wanted to repeat it so everyone understood where I have been coming from all along. I still feel very strongly that the major problem is the Congress. We hear all the talk about the President's budget right now. I would remind everybody that a President can recommend a budget, he can plead, he can yell, scream, shout, threaten, he can veto, but he cannot spend one dime not appropriated by the Congress of the United States.

That is the constitutional responsibility of the House and the Senate and no President has ever spent a dime not appropriated by Congress. So if Congress doesn't like the budget, if they don't like trillion dollar debts, if they don't like deficits, Congress is the only one that can do anything about that. That is a constitutional fact of life.

So if I sound angry, I am angry. I'm sick and tired of Congress trying to find everybody else to blame. The President, this one or Carter or some other President, or the Fed—to find everybody to blame except the Congress of the United States so they look good at home. I repeat, only Congress has control over fiscal policy, no one else. If we don't like Ronald Reagan's budget, we can change it. Instead of just trying to assess blame, we can change it. We can do anything we want with it. That power lies only here.

Having said all of that, trying once again to pinpoint at least where I feel the major responsibility lies, in these halls and in this body. Nevertheless, the Fed has a part in it and certainly monetary policy does influence interest rates. I have been critical of not going to contemporaneous reserve accounting. I also would hope you would address today the matter of reporting the monetary aggregates. As I have said many times to you privately, I don't even understand why we report them on a weekly basis. I don't think the Fed can accurately measure the money supply on a weekly

basis, let alone manage it. I don't think that's a possibility. Yet every week when those figures come out we see great ripples in the stock market and money markets of this country. Then a few days later we revise it and we find out that very rarely is it accurate. I don't see why we even report the monetary aggregates more often than once a month. I think we cause false psychological signals in the economy that are damaging simply because we are reporting them more frequently than we can accurately measure those figures.

So I think there's contemporaneous accounting I would like you to address and the matter of how often we report and collect the data.

Then there's one other thing that I'm beginning to be extremely concerned about, despite all I've said about where the major blame is. I don't want that misunderstood; I want that very carefully understood where I think the major blame is. Nevertheless, with the continual policy of the Federal Reserve and the tight money policy—I don't want it opened. I don't want to see what happened in 1980 and see rates drop to 12 percent and then immediately after the election go to 21.5 percent as they did. I don't want to see that kind of fluctuating market, but I'm really wondering if the Federal Reserve Board sitting here in Washington is aware of what is going on in the country.

I feel there's a great deal of insensitivity to the problems in the business community and what I'm essentially saying is, fine, inflation is down; what if we get it down to 4 or 5 percent? We haven't got any business community left, because in my own State, where the economy is much better than most of the States of this country, where the unemployment rate is not nearly as high as it is in Michigan—in fact, it's dramatically lower. Yet there's a softness in the business community that is going to show up very rapidly where it isn't just businesses that are undercapitalized or those that have been in business 4 or 5 years that are on the verge of bankruptcy, but some of the most stable businesses in my community and my State, some of them family-owned businesses—one that has been in business through 4 generations for over 105 years will be in receivership within 1 month for one reason—high interest rates. That's all. They simply can't carry their inventory any more, after 105 years of being very successful.

We all know the homebuilders' story. We all know the problems of the thrifts. I'm simply asking you to address, if you can today, is the Board sensitive to those problems? Are you going to be so persistent on your tight money policy and say that, fine, we will get 5 percent inflation but there are 1 million people unemployed, a few old-line businesses that have been around 75 or 100 years that aren't here any more—where is our industrial base?

Again, I think I have assessed rather adequately where I think the major problem is, but I'm wondering if the Fed is aware and recognizing the real world or are you so set on a policy, so persistent on it, that you can't bend regardless of the real world consequences of that policy, at least whatever part the Fed plays in that?

I will continue, Mr. Chairman, to do everything I can to see that Congress does its job on fiscal policy because I realize yours can't

be successful unless there is a responsible fiscal policy. But I think it's time maybe the Fed reassessed those targets, to see whether they are adequate or not, and particularly how often you report those. At least we could cut down some of the psychological impacts that are part of interest rates and the problems it's causing.

Well, I took longer than I intended to, but I'm sure we will have time to discuss at great length some of the points that I have made. Senator Proxmire.

Senator PROXMIRE. No statement.

The CHAIRMAN. Senator Schmitt.

## OPENING STATEMENT OF SENATOR SCHMITT

Senator SCHMITT. Thank you, Mr. Chairman.

I congratulate you for your statement and concerns and it's good to see Chairman Volcker with us again.

Chairman Volcker apparently yesterday hit a good middle ground. I see by the New York Times that they are quoting you as going to maintain a tight-money policy, whereas the Washington Post says you're going to ease controls. So maybe later in the day we will find out exactly what you're going to do.

The CHAIRMAN. They're in the same position in both papers. The New York Times says you are going to tighten it and the Post says you are going to ease it. Do we have anybody that's in the middle?

Senator SCHMITT. You know, what happens when you're in the middle of the road? You get run over by both sides.

So, again, I'm sure that you will enlighten us further.

Mr. Chairman, the Republicans as well as others have done a good job in recent years of selling the proposition that deficits are inflationary. Clearly, there is a competition for credit when the Government must go into the private markets to finance their debts. That raises interest rates. And this does contribute to inflation, depending on how you calculate interest rates into the calculations of the Consumer Price Index.

However, when I look at the historical curves, which are certainly more accurate than current curves, there is no strong correlation between an actual deficit and an increase in inflation taken solely by themselves. There is a correlation, as you're well aware—a historical correlation between increases in the money supply and increases in inflation.

Now that correlation is shifted by eight quarters. That is, the peak of inflation will appear about eight quarters after the peak in the increase in money supply, but it's a very, very strong historical or empirical correlation.

This suggests that what happens and the reason deficits appear to contribute to inflation is that we have monetized these deficits; that is, we printed money effectively in order to finance them.

So one of the things that I hope that you will address is whether or not you believe that the Federal Reserve System can avoid monetizing or printing money in order to finance the large deficits that are forecast for the next few years.

Clearly, interest rates will be affected by those deficits to some degree, if only that it's going to be more difficult for them to come down with the Government in the marketplace borrowing money,

but still we can avoid major increases in inflation if we avoid monetizing the debt. That will be the thrust of my interest and I hope that you can cover that.

Welcome again to our hearing.

The CHAIRMAN. Senator Riegle.

## OPENING STATEMENT OF SENATOR RIEGLE

Senator RIEGLE. Thank you, Mr. Chairman.

Chairman Volcker, we have had occasion before this committee and on other occasions to get into these issues, so today is just a further step in the discussion that's been continuing over a period of time.

But in terms of an initial statement, Mr. Chairman, I want to relate what I'm about to say to some of the things that you, yourself, said a minute ago.

First of all, Mr. Chairman, the economy of this country simply cannot tolerate the continuation of these high interest rates. You are doing massive, permanent damage to the economy and, yes, while we have made some progress on inflation—and I think that's important—we also have on our hands now a major recession that's getting worse. We now have in our country about 30 percent of our plant capacity idle, unused. We've got at least 10 million people in this country unemployed that want to go to work and can't find work. We are seeing tremendous damage to the automobile industry and to other heavy industry in this country, to small business, to agriculture. The construction business has shut down. The savings and loans are failing at a rate, according to Mr. Pratt, of essentially one a day. We just had a run on a savings and loan, as you know, in Connecticut.

In my State of Michigan, the unemployment rate last month jumped to 16 percent. It went up a full point and it's still rising. We've got 677,000 people in my State that are unemployed that we know of by name. There are easily tens of thousands of others unemployed in Michigan that we don't even count any more because they have exhausted their unemployment benefits.

So we have a disaster on the scale that rivals the 1930's, as I see this spreading out across the country, through the tier of Northern States, out in the far Northwest, in the Northeast, and beginning to penetrate even into the Middle Atlantic States and down into the Sun Belt and into States like Alabama and Tennessee.

Now something has got to be done about this. As I look around my State, we've got not only the disaster in the automobile industry but we've got a major company close to chapter XI at the present time. I can cite for you hundreds of cases of examples of small businesses that have been in families for two, three, and four generations, well managed, that have exhausted their working capital and can't function at a prime rate of 16.5 percent, and many of them, by the way, can't even borrow at that rate, as you well know, and basically the answer that comes back is that nothing can be done about it in the short run, that nobody can do anything about interest rates. The Federal Reserve apparently can't do anything about interest rates, but I just can't accept that. I think you do have some responsibility to find a way to take specific actions that

can bring down the interest rates and if you need help, if in fact you do, both from the Congress and importantly from the Reagan administration, I trust you will ask for it bluntly here and I hope you are going to ask for it bluntly at the White House if you find you need additional operational authorities within the Fed to bring these rates down, to create a two-tier system or try to get some credit into the sectors that are starving to death. The President has the power to see that you do have it under the Credit Control Act and he could do it within 24 hours. If you feel there's a need for that, then I don't think you should be reluctant to ask for it, and if you're reluctant to ask for it, then I think perhaps there's a need for you to take a closer look as to what's actually happening around the country and the scale of damage that's piling up here.

Now these interest rates I think are unfair, they are unsound, and they are unjustified.

Another problem mentioned is that the deficits are too high, they are too high, and they have to come down, and I pledge—and most of the Members of the Senate are pledged to get these deficits down below the $100 billion range. But it is important what the President of the United States does. If he comes to Congress with a budget, as he has, which projects deficits of $100 billion or more as far as the eye can see into the future, it is very difficult, very difficult as a practical matter to substantially reduce those deficits.

So what the President thinks, what he proposes, is profoundly important, especially so when his party controls the U.S. Senate. I don't know, for example, how you feel about the size of those deficits in terms of your testimony here today, but if you think they are too large, as I happen to think they are too large, it's important that you say that to the President and that you say that to the Director of the Office of Management and Budget and to the other people who put the budget together and present it to Congress. I think the deficit is too high and it has to come down, but if it comes down and there's no monetary easing, if interest rates don't come down, I think we run the risk of the real possibility of a depression in this country. I don't even like to mention that people like Helmut Schmidt have been talking about it here in this country within the last several weeks, have been raising the possibility as more and more people do, and I think we've got to be realistic about what we are facing.

There has to be a recognition of what's happening to the country and I think you've got to find a way to engineer a response within the next 90 days and I would feel within the early part of the next 90 days, and not let the current situation drift on for an additional series of months. I have been out, not only across my State and in cities like Detroit, but across the country talking to people at all levels, and what I'm finding is this: that the level of economic and social stress that's building up in this country is such that we are going to have a very hard time holding this country together the remainder of the year.

We've got to get interest rates down, that has to be a common goal among us. I'm very interested not only to see what plans the Federal Reserve has for accomplishing this objective this year and quickly, but I also want to ask you some specific questions in regard to that and I will when my chance comes.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Lugar.

## OPENING STATEMENT OF SENATOR LUGAR

Senator LUGAR. Chairman Volcker, I appreciate your coming this morning and I appreciate the testimony that you have given in the past and the work that you're doing. It seems to me that you have analyzed correctly, at least in recent statements, the fact that a collision course may be ensuing as the growth policies of the present administration and the present congressional dictates collide with restraint of inflation.

It seems to me that in defense of the course that we are on—and it's one that I voted for—it's important that we appreciate that we cannot pay our bills in this country unless we have dynamic growth, that there is no way that we can pay for social security or the transfer payments or defense without substantial new growth, that the rationale for tax cuts was to offer opportunities for people to bring about that growth in the private sector and I think both parties are united in praying that that will be so.

It also appears that in order to get to the promised land of the Tax Recovery Act the barrier of interest rates must be surmounted and they are too high. As a result, that investment is not occurring and income is falling and the deficits become larger.

It's in that context that I did make a constructive suggestion that is not unique but simply, I suppose, in the spirit now in which alternative ideas are offered if one has some change of course in mind. It appeared to me that it would be advisable either as a public statement or as a private policy for the Federal Reserve Board to adopt a policy of pegging interest rates 3 percent above the perceived rate of inflation in this country. There could be disagreement as to what that perceived rate is, but presently, for the sake of argument, let us say that it is somewhere between 8 and 9 percent. That would mean that the prime rate ought to fall somewhere between 11 and 12 percent. It seems to me that ought not to occur in a precipitous fashion, if it's now at 16.5 percent, and that the policy of the Fed ought to be for an incremental reduction of approximately one-half percent per month until such a time as we get into the general range of that inflation plus 3 percent formula.

There are any number of technical problems in making that occur and I'm mindful of that, in case anybody would charge that this idea is simplistic. But at the same time, it appears to me that that needs to be our goal, that we need to have a real rate of interest that is roughly 3 percent and not 6 or 7 percent, and it probably needs to occur during calendar year 1982 in the foreseeable future.

This may require a certain degree of negotiation with the President of the United States and I have no doubt that you are prepared for that and I'm very hopeful that he will be too. It appears to me that it is in the best interest of our country for us to get on with the recovery and that the degree of investment that we wish to have must come soon and that the relief that I'm suggesting must be timely. I offer this fully mindful of the fact that in the inflation the genie is still barely in the bottle and the possibilities of it escaping are enormous, but I also think that we are dealing in

futility in discussing deficits without thinking of revenue coming in, and that in order for revenue to come in we shall have to have fuller employment, much greater investment, and that the barriers of interest rates prevent this.

I'm certain that we will do our part, as all members have pledged, on the fiscal side, and will entertain alternative ideas hereto in the same spirit that I offer an alternative with regard to monetary policy.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Dixon.

Senator DIXON. Thank you very much, Mr. Chairman.

I'm delighted to welcome you back again, Chairman Volcker. One of the prices one pays for being the low man on the totem pole in a committee is that many of the things you might say are somewhat repetitive of what your colleagues have already said.

May I first ask leave, Mr. Chairman, at the appropriate time to put some remarks in the record that I prepared for this occasion?

The CHAIRMAN. Certainly

[Statement follows as though read:]

## STATEMENT BY SENATOR DIXON

Senator DIXON. Last Friday afternoon the administration's fiscal year 1983 budget was delivered to the Congress. The new budget embodies the President's proposals for restructuring the Federal Government and reordering our priorities, and lays the groundwork for his "New Federalism" proposal.

On Monday, the stock market reacted to the budget proposal—it dropped over 17½ points. I want to highlight the market's reaction to make it clear that it is not just the poor, not just the minorities in this country, not just small business, not just homebuilders, not just labor, not just the auto industry, not just Democrats, who have concerns about the administration's fiscal year 1983 budget—Wall Street also appears to have serious concerns!

I share their concerns. Like the financial community, I am extremely concerned about the size of the projected fiscal year 1983 deficit—$91.5 billion—and by the absence of any indication as to when the budget will be balanced. Like many other Illinoisans, I am disturbed by the scope, the extent, and the complexion of the budget cuts in social programs while military spending increases by almost 20 percent.

As we all know, the economy is in serious trouble. Unemployment is currently 8.5 percent and will, unfortunately, probably go higher. Inflation is declining, but the prime rate recently rose to 16½ percent suggesting that interest rates are starting to climb again.

The administration, it seems to me, has not yet reconciled the inherent conflicts that underlie its policies, and the budget itself provides clear evidence of the impossibility of simultaneously financing large increases in military spending, balancing the budget, and cutting taxes by huge amounts. Tight monetary policy, when combined with large Federal deficits, has proven to be a recipe for continued high interest rates and economic stagnation.

I do not mean to be critical of the Federal Reserve Board for holding to a tight money policy. I tend to agree that restraint in the rate of growth of the money supply was and is necessary to bring down the inflation rate. I do not agree with those, including some officials in the executive branch, who put prime responsibility on the Board for the too-high interest rates that are causing such damage to our economy.

It is time to stop casting around for villains, and to begin working together to solve the problems facing our economy. Last year, the Congress gave the President the program he wanted. However, it is becoming increasingly clear that policies put into place last year need to be adjusted, need to be modified, in order to reduce unemployment and bring down the high interest rates that are paralyzing the auto and housing industries.

Our budget priorities need to be reconsidered. We need to bring the budget into balance as soon as practicably possible. I have supported substantial budget cuts in the past, and I will support reasonable and appropriate cuts in the future. Budget cuts, however, are only a partial answer to the deficit problem we are facing. We must also look at the revenue side of the budget.

Starving the Federal Government of the revenues necessary to fund legitimate and appropriate government activities will not solve our economic problems. Supply-side economics, using the administration's own figures, does not appear to be generating enough economic growth to permit us to balance the budget using the present tax base. Tax cuts enacted last year for business, in particular, may be larger than appropriate. As recently as 1975, 16 cents out of every revenue dollar came from corporate taxes. In 1982, however, the estimate is that only 9 cents will come from corporate taxes. Elimination of undesirable and inappropriate tax provisions, therefore, such as the safeharbor leasing provisions, must be a high priority. Other tax breaks enacted during last year's bidding contest should also get careful review.

The third year of the individual across-the-board tax cut may need to be deferred in order to help close intolerably high Federal deficits.

Further we need to carefully review the proposed budget cuts to insure that essential Government activities are continued. I am very concerned about the impact, to take just a few examples, that the cuts in housing, education, and transportation will have on my State.

The proposed housing program cuts could make it difficult for most Americans to obtain financing for their homes, while making it virtually impossible for many poor Americans to obtain adequate housing.

Education cuts could result in forcing many of our college students to leave school, a shortsighted approach which could hurt our ability to compete in a fast-paced, high-technology world.

Transportation cuts increase the difficulties facing States and local communities in maintaining essential highway and public transportation systems, systems which are wearing out much more rapidly than they are being maintained.

It is difficult to see how the budget is to be brought into balance by cutting social and infrastructure programs that account for less

than 35 percent of the budget while simultaneously increasing the defense budget by almost 20 percent. I strongly support a strong national defense posture, and I agree that increases in defense spending are necessary. It sometimes seems to be forgotten, though, that our national security does not solely depend on our military budget. Our security is also related to the strength of our economy. Without a strong economy, we can never be secure.

Our first priority, therefore, must be restoring our economy to its former healthy state. We need to put Americans back to work. We need to improve our productivity, which has stagnated in recent years.

Continued high interest rates caused in no small part by unending Federal deficits make achievement of these objectives difficult, if not impossible. Fiscal and monetary policy must work in concert. I hope we can work together toward a program that brings fiscal policy into harmony with monetary policy—a program that will enable us to make progress toward a balanced budget, while insuring that essential Federal programs are continued.

I would like to make, if I could, Mr. Chairman, three points that I think are worth making, even if parts of them are repetitious.

The first would be that I'm growingly concerned—and I think I sense that in the Congress and in this committee—about what might be a perception in some places that the policies that we have are only affecting those who are operating perhaps ill-managed concerns, those who are in marginal situations.

I would like to report, as all of us do, about my experience back home in my State of Illinois, where clearly I think it's evident that the policies are affecting well-managed, good business concerns.

First of all, I find that the farmers are in desperate situations in Illinois, as has been indicated by others here. Just the other day a friend of mine who's a hog farmer told me he's losing $20 a head on his hogs, and that a neighboring farm sold for one-half the value of another farm near at hand over a period of less than 18 months. In talking to a friend of mine who's a very affluent man in housing, who incidentally heard you recently, Mr. Chairman—I think you must have spoken in Nevada to their group—this man is wealthy enough to live in the country club section of town and drive an expensive automobile and send his children to the finest colleges. He's now laid off his firm, including his superintendent and all of his employees.

A friend of mine in the Chevrolet business told me he can't make it any more. A group of thrifts from my State came in and told me that July is the deadline, that 85 percent of the thrifts in my State are in desperate circumstances.

That's the first point I wanted to make about this situation we have now.

I think the second is this, and I would wonder if at some appropriate time in the period today you might address this. I think clearly some things need to be done on the revenue side as well. It seems clear to me that there are not the possibilities available in this budget for cuts that can approach the kind of a benign—if there is such a thing as a benign—budget deficit situation that will encourage the money markets. I think we have to look at the third year of the tax cut. I think we have to look at the lease provisions

of the bill. I think all of those things are necessary to work towards a balanced budget in the next several years, and then finally, I'd like to share with my colleague, Senator Lugar of Indiana, that the last time I was home I met with three economists in my Chicago office of different political and philosophical persuasions. The one thing that they were unanimous about was that they felt the Fed has to look at the interest side as well as the supply side, as has been done in years past. I don't know what formula would be a proper one. Senator Lugar has suggested 1 of 3 percent over the inflation rate, but certainly something that would bring us back into a sense of understanding of what's occurring because we have these interest rates going back up again now, this feeling of desperation among the folks back home in the business community, and apparently now, at least at this stage, no hope for the immediate future. I think we have to give them at least some hope about what's going to occur shortly or we're going to have, as Senator Riegle, my friend from Michigan, has suggested, some very desperate things occurring in this country shortly.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Mr. Chairman.

## STATEMENT OF PAUL A. VOLCKER, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. VOLCKER. Mr. Chairman, I think my prepared statement which I gave yesterday before the House reviews in general terms some of the concerns that have been addressed by members of the committee. I won't repeat it here, but let me summarize some of the points in the statement; I actually commend it to you.

[Complete statement of Mr. Volcker and the report from the Federal Reserve are printed at the conclusion of this day's proceedings.]

Mr. VOLCKER. As far as the specifics of monetary policy that occasion these hearings are concerned, the Open Market Committee did adopt the targets that they tentatively adopted last July and reported to you at that time; that is, 2.5 to 5.5 percent for M1, 6 to 9 percent for M2, and 6.5 to 9.5 percent for M3.

I think that appropriately reflects the continuing thrust of our policy. We won't resolve all the semantic difficulties that are reflected in the varying newspaper stories I'm sure, but I think those targets are meant to convey the message that the basic thrust of our policy is the same, and we have to continue to restrict the growth of money and credit.

As you know, we came out a bit on the low side on M1 last year. We told you in July we wanted to be near the low point. We were about 1.25 percentage points below the low point of that target. The performance of that target ran low partly, in our judgment, because of technical reasons; the rise in the use of money market funds, in particular, depressed the demand for M1.

Looking ahead, and knowing that that target is based upon the actual fourth quarter figure for 1981 as has been the convention, I indicated that at this time we felt an outcome in the upper half of the range would be acceptable, and I also indicated that the bulge

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that we had in January could well and appropriately mean at this point that we will run somewhat above the growth track for a while. For $M_2$, I think the targets are consistent with some reduction in $M_2$ growth from what we had last year. Both of those numbers, particularly $M_1$, have to be evaluated in terms of what we, perhaps not informatively, call technological change in the markets that cause shifts in the use of various kinds of accounts; that needs constant surveillance to make sure the targets mean what we want them to mean in terms of reductions over time in the money supply.

We do believe those targets are consistent with progress on inflation, and we believe that they are consistent with some economic recovery later this year.

In assessing the extremely difficult current situation that we are in—that all of you have referred to in one way or another—we are aware of the problems. I want to emphasize that they are part of a larger problem. I don't think we have just another recession in a series of recessions. The situation has some of those characteristics of an ordinary recession, but it also seems to me to represent the culmination of increasingly unsatisfactory economic performance over a series of years—whether you look at inflation, which is in considerable part responsible, in our judgment, or whether you look at lower productivity, or whether you look at the fact that unemployment has been trending higher for a decade apart from recession. If you look through the cyclical developments, we have an economy that is performing less satisfactorily over time.

We are not going to build a permanent or lasting improvement in the inflation rate on an economy in recession. The object has to be built in some forces in the economy that can be consistent with recovery and declining inflation at the same time; we think those are two sides of the same coin. If, indeed, we are not successful in doing that, the prospects—whatever they are for the near term—would be a prolongation and maybe an acceleration of the trend of unsatisfactory economic performance over a period of time.

Reducing inflation is really the object of the policy, and it's not and can't be a matter of monetary policy alone. If you rely on monetary policy alone to achieve it, there's going to be much more trouble and difficulty than would otherwise be the case.

We have seen some considerable improvement on inflation in the past year, and I could cite you a lot of price indices that reflect that. You're familiar with those indices. The point I would make is that we realize some of that improvement could be of a temporary character if we just abandon the policy direction now—temporary in the sense that some of it reflects cyclically weak markets, and some of it reflects the impact of high interest rates on inventories, and other matters.

The most heartening thing is that I think we see signs of improvement of a more permanent character. We are just beginning to see those, but I think we are seeing them. You see some of the evidence as well I'm sure: The basic cost-wage-productivity nexus is being attacked by business; there are signs of improvement particularly in the manufacturing area. The signs are less clear elsewhere, but this process seems to us to be beginning and the general progress on inflation is important, even though it may have temporary

elements, because it provides a platform for more permanent improvement to ensue. The vision that I would like to offer to you is an economy that, as it recovers, shows improvement in productivity; that improvement in productivity, for the first time in a number of years, will permit real earnings and real profits to increase, consistent with lower nominal wages and restraint on costs; it will help keep the disinflationary process going; it will contribute to a reduction in these extraordinary levels of interest rates that we see, which will, in itself, promote the investment process. As the investment process is promoted, the productivity side of the equation will be improved and help keep the process going.

Against the performance of the last decade that may seem like quite a vision to you, but I would point out that we saw something like that in the early 1960's. Indeed, I think we began to see something like that in the mid-1970's when we came out of that recession. We went 18 months or 2 years into that recovery with declining prices; we went into that recovery at sustained lower interest rates for quite a while. Then we got off track and fell back into the morass of inflation and poor performance that had begun building up in the mid-1960's.

When one looks toward that kind of future, one obviously has to think about the ingredients that make it possible. We think the continuing restraint on monetary and credit growth is a necessary part of the disinflationary process. You have heard me speak to that point many, many times, and I won't elaborate further right now.

I think there are some other problems and needs out there as well. I refer to the fact that we are beginning to see progress on the productivity-wage-cost side. I realize that productivity is not improving in the midst of a recession, but I think we see things going on in industry that augur increases in productivity as the economy recovers, and, of course, last year's tax bill was aimed in that direction as well. It's terribly important that that process proceed as fast as it can, because that will help the financial markets; it will help the inflation and give us more room for recovery.

The other major question mark—and in this case hazard—that I would emphasize, is the budgetary situation. So far as I know, we are in a budgetary situation that has no parallel—in my memory anyway—in history. I say that in this sense: Whether one looks at the administration figures for the current services deficit with adequate defense—in other words, unchanged nondefense programs and an unchanged tax position—or at the figures produced by the CBO or by a number of outside analysts, we have a situation where if one makes the assumption of a healthy, continuing recovery, with the impact that that has on revenues, you have a widening deficit year after year beginning at a high level.

The deficit this year in the neighborhood of $100 billion is in very considerable part a symptom of the recession. I don't focus my attention on that particular deficit because it is very much recession-influenced. Indeed, in the midst of a recession, when you expect some slackening of credit demands, when the economy needs support, the deficit is not inappropriate—even a relatively large deficit.

What does greatly concern me is that the deficit doesn't decline as the recovery proceeds and as you get the impact of revenues from a recovery. It increases. The administration has projected on that basis a deficit close to $150 billion, and the CBO has projected a deficit of over $150 billion. The administration projects a deficit of $165 billion in the following year and $168 billion in the following. The CBO figures, I think, run higher than that.

If you put those figures in any kind of a context—deflate them or relate them to GNP—they are historically very high. They are extremely high for a period of recovery and imply a kind of draft or preemption of our savings ability that simply doesn't leave much room for the revival in homebuilding or the revival in investment that we want to see. Nobody can separate out the weight of all the influences, but certainly a very considerable weight lies on the financial markets at present. When one invests in a financial market, one always is looking to the future. The weight lies very heavy on the financial market of that potential future competition for money out there in the years lying ahead.

It does seem to me essential that as we work, and work urgently, not simply toward recovery in 1982 but, more importantly, toward sustaining that recovery year after year, that we have to deal with that very large and looming financial problem reflected in the figures that I just summarized.

The President has made proposals in that direction. One can argue about whether those proposals in themselves are large enough. I would certainly urge an even larger program in that direction. Just what is necessary depends upon assumptions about the savings rate and other factors, but what stands out—apart from any debate about precisely how big the program needs to be in 1983-85 and the years beyond—is the very large nature of the numbers, however one puts them together. The administration has proposed some very sizable cuts. The only question there can legitimately be is whether they are big enough. I leave that with you as a major point of hazard for the financial markets today, for the financial markets in the future, for our ability to finance the growth and investment that we need, and as part of the outlook for monetary policy and, more importantly, for the economy as a whole for a recovery that is combined with productivity and disinflation.

With that, we can turn to your more specific or general questions if you wish, Mr. Chairman.

The CHAIRMAN. Thank you, Mr. Chairman.

First of all, before we talk about monetary policy, I would like to pursue the fiscal policy more in specific terms than I talked about in my opening remarks. Again, it's very easy to find someone to blame and as far as short-term interest rates, I do believe that you can have considerable effect on short-term interest rates. On long-term interest rates, I don't think it makes much difference what you do as Chairman of the Fed or what the Federal Reserve Board does, regardless of what some of my colleagues may want to indicate that you can run down and talk to the President and all you've got to do is talk about it and decide on where you're going to put the interest rates and monetary policy and make it all come out. That's a shortsighted and naive thinking about how the economy works as I've ever heard.

It may be good in a political election year, in 1982, to say we've got a Republican Senate and Republican President, and that's true for a year, and don't look back at the fact that we had a Democratic Congress for 26 years. I don't think it makes any difference one way or another. This country is in a big enough problem that I'm to the point I don't care who's Republican or who's Democrat or who's in power. I want to know if my kids are going to be able to buy a house in the future. I've six and three-fourths of them and I don't know whether they can answer that question or not.

But the point of the short-term versus long-term interest rates——

Senator SCHMITT. Don't blame the Fed for that.

ENTITLEMENT PROGRAMS

The CHAIRMAN. I'm not blaming anybody but myself. But the point that Congress, both Republicans and Democrats, and this administration will not face up to or have the political courage to face is where the real fiscal problem is, and that's in the entitlements programs. I want to see if you agree with this.

Forget this year's budget deficit and forget next year's budget deficit. The money market managers that I talk to, what they are looking at is not the short years; 1984 is not an outyear to them. They are looking at 1988 and 1989 and 1990 and 1991 and 1992, and all they see is the Federal budget that is expanding automatically, outside the control of Congress, and they are not dumb enough to say we are going to loan money on a 20-, 25-, or 30-year basis with that kind of a projection. So we cut $50 billion out of the 1981 and the 1982 budget and $14 billion rescissions in 1981. That didn't impress the money markets, not the long-term money markets, because, again, that has no impact whatsoever on the outyears because essentially, in very round numbers, about 70 percent of the budget is uncontrollable. That simply means in the Appropriations Committee we can't control that, like food stamps. We can't cut back the money unless the eligibility requirements are changed by an authorizing committee. So essentially where we have taken most of that money is out of discretionary programs, essentially one-time savings per year.

The uncontrollable part of the budget is growing at about 16 percent per year compounded. As an example, in my HUD Subcommittee, I could eliminate NASA, just wipe them out, say we are not going to have a space program any more and save $6 billion a year. I don't mean to minimize the $6 billion. That's a lot of money. But that's all it would save. You can delay a cost of living—to show you the magnitude of the numbers—the cost of living increase, social security, for 3 months—not cut it, not reduce it, just delay it for 3 months, and save almost as much as you would save by eliminating NASA completely. So that part of the budget has been virtually untouched.

The Reagan administration is afraid to touch it. Congress is afraid to touch it. And unless we are willing—not to cut—I don't want to have anybody say I'm advocating cutting social security, please understand that—I don't want all the mail I would get from that kind of report going out——

Senator SCHMITT. It's too late.

The CHAIRMAN. But if we're not willing to look at federal pensions, military pensions, social security and slow the growth, not cut anybody—slow the growth, we will not solve that problem. You could take every proposal that exists—cut the military $30 billion, take off the third year of the tax cut, delay the 10 percent next July to January—every proposal you've heard of, and I submit to you that budget would never be balanced if all those proposals were put in. You would not reach a balanced budget. It's impossible if that continues to expand 70 percent of the budget at 16 percent per year. The end will never meet—now are you in accord generally with that—unless Congress and this administration is willing to start telling the American people the truth that all these others are not going to solve the problem unless we slow that tremendous growth in the automatically indexed programs?

Mr. VOLCKER. I think you have obviously put your finger on a major part of the budgetary problem. Some of that 16 percent growth that you referred to is a reflection of inflation, and I hope we correct that over a period of time. But there are some basic demographic factors at work that push those programs higher over a period of time, even if benefits are not changed.

The CHAIRMAN. As you noted, Mr. Chairman, I said "slow the growth." I understand what you're saying. There is going to be growth. It is the rate of growth that has to be slowed to show those money market managers in the out-years that that curve is going to level off and start down. I don't believe you're going to have any permanent change in long-term interest rates until that is done, regardless of all the short-term palliatives we try to take for an election year.

Mr. VOLCKER. I'm not sure our problem is quite as impossible as your statement may imply. I think you obviously have pointed to a very major problem. It goes, in part, to the basic financing of those programs, how they're financed, and the relationship is between revenues and the rising benefit levels for demographic and other reasons. Those have to be studied; they are being studied and I hope some constructive proposals will come out in terms of the very problem that you cite.

I would not be so optimistic, if that's the right word, as to feel that the Congress in the next few months can fully deal with the problem that exists 5, 10, or 15 years from now. But I would be more hopeful perhaps than your statement suggests.

The CHAIRMAN. Mr. Chairman, let me interrupt you there because if I haven't learned anything else on this Committee after 7 years it's how important psychology is in the marketplace. Don't misunderstand me that I'm saying if we start to slow down the increase in those entitlements we're talking about a problem 10 or 15 years down the road. No, I'm not at all. I'm saying if those signals are sent to the marketplace that that is going to be coming down 5, 10, and 15 years from now, you're going to see an immediate impact on long-term interest rates now, not 10 or 15 years from now.

NEAR-TERM PROBLEM

Mr. VOLCKER. I think you're anticipating the point that I was about to make. I think what you can do in the near-term perspective, whether in entitlements or elsewhere—and entitlements are a part of the problem—is to attack the near-term problem. By near term, I'm certainly not talking about 1982; I'm talking about 1983 and 1984, which are immediately in the market sight. What you do for 1983 and 1984 is going to have immediate spillovers into the immediately following years. By attacking that problem sufficiently boldly, I think you give the kind of market signal that you suggest, and an implication, at the very least of a followthrough for that longer term period. If you're not concerned about 1983–84, it's a little hard to be convincing to the market that you're going to be concerned about 1987, 1988, 1989, or 1990. Of course, there are, apart from the psychological effects, which are very important, the more immediate—over a 2- or 3-year time horizon—market effects, that is, the direct impact of that kind of financing on the market.

I think the best signal you can give, keeping very much in mind the longer term perspective that you have usefully given, is a bold attack on the immediate 1983–84 problem.

The CHAIRMAN. Mr. Chairman, before my time is up, let me turn to monetary policy and some of the things I mentioned about contemporaneous accounting.

Writing in the February 15, 1982, issue of Newsweek magazine, Milton Friedman points out the Fed's October 1979 announcement that henceforth the focus of monetary policy would be on controlling the aggregate growth rates as follows: Not by steadier growth in the aggregates but by unprecedented volatility, how do you explain this unprecedented volatility and would you please restate your position on Friedman's thought in the same article, the replacement of lag reserve accounting by contemporaneous reserve accounting, which I've encouraged you to do for sometime—I agree with Mr. Friedman on that—selection of a single monetary target to replace the Fed's juggling between targets equalization, reserve requirements on all the deposit components of a selected target, and linking the discount rate to the market rate?

Mr. VOLCKER. You have made quite a few points which I'll try to remember and take up.

The CHAIRMAN. Do you want the issue of Newsweek to reply to?

Mr. VOLCKER. Not really. As far as the volatility issue is concerned, we can talk at some length about that. I think it might be useful if I submitted for the record, just so you could have it in perspective, the record of volatility in the American money supply as compared to the volatility in other countries. (See pp. 20–21.)

The CHAIRMAN. Because of limits of time, I would appreciate it if you could give me a more detailed written accounting of this whole area Mr. Friedman discussed.

Mr. VOLCKER. I would be glad to. (See pp. 114–119.) I would just summarize that evidence by saying that in terms of these international comparisons with countries which I suppose you would think have very good monetary policies—maybe some countries you think have less good monetary policies—in the international league, the American fluctuations stand out as extraordinarily stable. I find the only

country that seemed in the last couple of years to have a more persistently stable money supply is Italy, which has had some rapid expansion but where money supply seems to proceed month after month fairly steadily.

I constantly get comments from my foreign central banking colleagues that we pay too much attention to stability in the short run. What counts is the trend over time. I think what counts is the trend over time, too, and I don't know of any economic analysis that suggests that the short-term ups and downs have any real effect on the trend of economic activity or the trend on inflation.

We could, theoretically, for purposes of discussion, adopt some techniques to try to enforce greater rigidity in the movements from month to month. Is that a good idea or a bad idea? I think you have a trade-off between short-term instability in interest rates—and you have plenty of that as things stand—and short-term rigidity of the money supply.

The American money supply is a quantity of about $450 billion or so. An enormous number of every day transactions are reflected in that and run through that money supply, and at the end of the day you run some cash balances which are collectively reported to us; we have about half a trillion transactions a day. How much do you want to enforce constancy on the cash balances that emerge at the end of every day given the natural fluctuations and the cash management practices—the desire to hold cash and all the rest?

I would say you want to leave a little breathing room there. You don't want to enforce absolutely stability—I'm speaking in extreme terms now; the practical problem is one of degree—on a particular quantity that's buffeted and affected by technical changes, by passing desires to hold more or less cash, by the number or volume of transactions going through the market, by motivations that may be short term in character. You arrive at some judgment as to where the appropriate compromise is, where you can bend without giving in terms of the trend, which I think is preferable and certainly reflected in the figures, and that seems to me the appropriate position to be in. I don't think we could enforce perfect stability under any circumstances.

### CONTEMPORARY RESERVE ACCOUNTING

You raised the question of contemporary reserve accounting. That's something we have studied for a long period of time. We put out a proposal a few months ago that, in my judgment—I have not yet seen all the comments; we are about at the end of the comment period—seem more promising as a technical, operational matter than some of the earlier proposals. It has some advantages as an operational matter, given the way we now operate. If we adopted Senator Lugar's interest rate approach, it would be irrelevant in that kind of an operating technique.

But given the way we now do operate, there may be some technical advantages. There are some operational difficulties imposed both for us and the banks. My major concern is in the way that this issue is blown up out of all perspective. It is not going to make any significant difference, in my judgment, in terms of economic or market performance over any relevant period of time. There is,

perhaps, some danger of simply overestimating some magical result of a change in technical operating procedures, and I wouldn't want to create the impression that it's more important than it, in fact, is, although it may have some technical advantages in the context of our current method of operating.

So far as the single monetary target is concerned, there's no question in my mind that would be a mistake. You're then at the mercy of every particular influence that may influence one aggregate in a way that does not have economic significance, and that would lead you on a course contrary to the underlying course you wanted to take.

Last year provides as good an example as any. We had relative weakness in M1 compared to some of the other aggregates. We had relative strength in M2 relative to M1, to put it the other way around. You're left with some judgment as to what's causing that divergence which is a little greater than we expected. What is the economic significance of that?

We had, in the first place, to make some adjustment last year for the introduction of NOW accounts. That's a dramatic kind of example. We had a big change in various measures of M1 earlier in the year simply because a lot of money was shifting into NOW accounts from accounts outside of M1. And if we had focused on one particular target and misjudged that shift or ignored that shift, we might end up with a substantive result at wide variance with what we really wanted to achieve.

Throughout the year we had explosive growth in money market funds, which have some of the characteristics of transactions balances. Economically speaking, you would put those funds in M1, but we can't put them in M1 because there's no statistic that jumps out from a money market fund and raises its hand and says, "I'm a money market fund account that's a transaction balance," or "I'm a money market fund balance just like a savings account and I don't belong in M1." We get the statistic in one undifferentiated mass. But, in analyzing them, it is clear that some fraction—some fairly small fraction of those accounts—is used as transaction balances and we should appropriately make some allowance for that in evaluating what's happening in M1.

At the same time, that money market fund phenomenon is counted in M2. We drew money into M2 that otherwise might have been in Treasury bills or elsewhere, but not in M2. We'd better keep that in mind also in evaluating these trends.

I think there is the danger of getting a misleading signal by adhering to just one target without evaluation of anything else going on in financial markets; it would be a mistake, and we are not prepared to adopt that approach. Indeed, a great many analysts—you mentioned only one—would then say which one target? You referred to Milton Friedman; unless he's changed his mind, he's often emphasized in the past, and as recently as last spring, that we should forget about M1 and look at M2. What do you do when you get different signals from M1 and M2? You referred in your opening statement to this question of reporting the money figures weekly; we have had a number of conversations on that point, as you indicate.

The CHAIRMAN. Mr. Chairman, if I could cut you off, I finished my question at the end of my 10-minute time, but your answer is lasting considerably beyond that. I do need to turn to my other colleagues, so I'd like your answer to that when it gets back to me.

Mr. VOLCKER. I can only say that you had quite a few questions.

The CHAIRMAN. I understand. I'm not blaming you. I'm just trying to give my colleagues an opportunity and I will be back to you and let you finish the answer to my questions.

[The following letter was ordered inserted in the record at this point:]

BOARD OF GOVERNORS,
FEDERAL RESERVE SYSTEM,
*Washington, D.C., February 18, 1982.*

Hon. JAKE GARN,
*Chairman, Committee on Banking, Housing and Urban Affairs,*
*U.S. Senate, Washington, D.C.*

DEAR CHAIRMAN GARN: In my recent appearance before the Senate Banking Committee, I agreed to provide for the record information on the fluctuation in growth rates of money in the United States compared with other industrial countries, which I am pleased to enclose. The data can be presented and analyzed from a number of perspectives. Even allowing for the technical difficulties involved in making such international comparisons, they all appear to demonstrate the same point: U.S. monetary aggregates rank at or near the top of the league in terms of low variability.

The enclosed two tables illustrate this point. The first table presents the lowest and highest monthly growth rates for M1 in 1980 and 1981. It also shows the range covered by those rates. The second table presents the same information for the same years using quarterly observations. In both tables the growth rates are presented at annual rates, as is unfortunately customary in the United States. This presentation, of course, tends to exaggerate differences.

The monthly results show that U.S. M1-B (shift adjusted) showed a narrower range of fluctuation in 1980 and 1981 than did the most nearly comparable aggregate in any other country except Italy. In the quarterly results, which in general exhibit much lower variability, only France and Germany had a range in 1981 approximating that in the United States. In 1980, France and Italy had a much narrower range of quarterly fluctuation in M1 growth, while the range in most of the other countries, with the significant exception of Switzerland, was close to that in the United States.

In interpreting these results, it is important to remember that complete stability in the growth of monetary aggregates is not an objective of monetary policy in the United States or in any of these major foreign countries. On the other hand, slower medium-term growth in the monetary aggregates (and monetary authorities abroad are increasingly looking at more than one aggregate even though they continue to target on at most one) is widely recognized as a necessary condition for a sustained reduction in inflation. In this connection, one might note that Italy, the one country that does "better" than the United States in three out of the four comparisons presented in the enclosed tables, has had one of the highest rates of growth of M1 (measured, for example, over 12 months or four quarters) and one of the highest rates of inflation in recent years.

I hope that these comparisons help the Committee to appreciate the difficulty of short-term aggregate control and the absence of an obvious link between our current economic problems and the short-term variability of our monetary aggregates.

Sincerely,

PAUL A. VOLCKER, *Chairman.*

Enclosures.

TABLE 1.—MONTHLY CHANGES IN NARROW MONEY IN SELECTED INDUSTRIAL COUNTRIES, 1980–81

[Percentage change from previous month; annual rates]

| | 1980 | | | [1] 1981 | | |
|---|---|---|---|---|---|---|
| | Low | High | Range | Low | High | Range |
| Canada | −17 | 35¾ | 52¾ | −40 | 87½ | 127½ |
| France | −11½ | 30 | 41½ | −6½ | 37½ | 44 |
| Germany | −16¼ | 30¾ | 47 | −32 | 28¼ | 60¼ |
| Italy [2] | −4¼ | 24½ | 28¾ | −6¾ | 16½ | 23¼ |
| Japan | −39½ | 51¾ | 91¼ | −44 | 93¾ | 137¾ |
| Switzerland [2] | −22 | 27½ | 49½ | −42 | 14 | 56 |
| United Kingdom | −17¾ | 43 | 60¾ | −29½ | 58¾ | 88¼ |
| United States [3] | −15¾ | 21¼ | 37 | −10 | 19½ | 29½ |

[1] Data are available through December 1981 except for the following countries: France (November), Italy (October), and Switzerland (September).
[2] Seasonally adjusted by Federal Reserve Board staff.
[3] $M_{1B}$ shift adjusted.

TABLE 2.—QUARTERLY CHANGES IN NARROW MONEY IN SELECTED INDUSTRIAL COUNTRIES, 1980–81

[Percentage change from previous quarter; annual rates]

| | 1980 | | | [1] 1981 | | |
|---|---|---|---|---|---|---|
| | Low | High | Range | Low | High | Range |
| Canada | −2 | 17 | 19 | −18¾ | 6½ | 25¼ |
| France | 6¼ | 10½ | 4¼ | 11½ | 15½ | 4 |
| Germany | −2½ | 11¼ | 13¾ | −4¾ | 1½ | 6¼ |
| Italy [2] | 6¼ | 15¼ | 9 | 2½ | 15¾ | 13¼ |
| Japan | −10 | 7½ | 17½ | ¾ | 22 | 21¼ |
| Switzerland [2] | −23½ | 5¼ | 28¾ | −13¾ | −1¼ | 12½ |
| United Kingdom | −6 | 11½ | 17½ | 1 | 21¼ | 20¼ |
| United States [3] | −3¼ | 14 | 17¼ | −1 | 5¾ | 6¾ |

[1] Data are available through December 1981 except for the following countries: France (November), Italy (October), and Switzerland (September).
[2] Seasonally adjusted by Federal Reserve Board staff.
[3] $M_{1B}$ shift adjusted.

The CHAIRMAN. Senator Proxmire.

Senator PROXMIRE. Mr. Chairman, one of the most astonishing parts of the economic dilemma we are in at the present time is the fact that we are in a very serious recession, real GNP fell, as you know, at a rate of 5.2 percent the last quarter of 1981, it appears to be falling at an annual rate of about 5 percent in this quarter; it's continuing; corporate profits were down 21.8 percent, a very sharp drop. We are operating at 73 percent of capacity overall. The homebuilding industry is operating at less than 50 percent capacity. The automobile industry is at less than 50 percent capacity. And unemployment, of course, at 8.5 percent is very, very high.

With all that, interest rates are rising. They have been going up for the last 3 months, since early December.

Now supposing this continues. Suppose interest rates rise this year and next year while GNP continues to sink and corporate profits continue to drop. We continue to have excess capacity at a very high level, unemployment rates high. What reaction will the Fed have, if any? What will you do?

Mr. VOLCKER. Of course, we do not expect that to happen.

Senator PROXMIRE. Of course not, but it may happen.

Mr. VOLCKER. We think our targets are consistent with some recovery, so you're citing a contingency and outlook that we don't think is a reasonable analysis of what is likely to happen.

If that happened, consistent with our monetary targets, we would look around and say, "Why is that happening?" You referred to this interest rate problem, in the short-term sense of an increase during a recession——

Senator PROXMIRE. It's very rare, isn't it? We have rarely had interest rates right in a recession.

Mr. VOLCKER. I think it's rare to have a combination of a rising money supply and rising interest rates with production and income falling for any period of time. I think that's quite right; that is a rare phenomenon. And among the influences in that area and one of the influences in the market situation, I just want to point out, is that budgetary situation. You didn't indicate just how that was being resolved in your scenario, but I just want to point out that that is an influence that is obviously beyond our competence and control, and it's an important influence and one would have to look at that.

Senator PROXMIRE. That's the most predictable part of it at least. It's not perfectly predictable, but we know deficits are going to continue at a very high level, no question about it, maybe $100 billion.

### REAPPRAISAL OF TARGETS

Mr. VOLCKER. In those circumstances interest rates would continue at extraordinarily high levels, because you get an addition to these already very large deficits. The only general answer I think I can give you, if you portray that kind of scenario, is that obviously, among other things, we would have to go back and see whether something fundamental isn't going on that suggests that the kind of calculations that one bases the money supply target on are wrong, that there's some fundamental change in behavior that would require reappraisal of these targets. I think it's quite clear we would do that if for some reason they seemed fundamentally off. I don't expect that to happen.

Senator PROXMIRE. Under those circumstances you would reconsider your targets and possibly change them. Is that right?

Mr. VOLCKER. If you had a situation, let's say, where inflation was declining and the economy was declining too, and the inflation thing was showing a lot of progress, but for some reason—I don't think this is going to happen—individuals or corporations wanted to keep much higher cash balances relative to economic activity than has been the record over a long period of time, obviously you would have to question the targets.

Senator PROXMIRE. Well, now, let's take the more likely situation—or we hope it's more likely. Supposing real GNP picks up, corporate profits increase, homebuilding and autos revive to some extent. What is there to make us think we won't have exactly the same problem we had in 1980 and 1981 with high interest rates rising more rapidly and choking off that recovery before it's becoming healthy and before it gets to a sustainable period?

Mr. VOLCKER. I think I'd make two or three points. You're starting this from an extraordinarily high level of interest rates relative

to what I think is a reasonable outlook for inflation. The market is reflecting a lot of short-term uncertainty, a lot of instability in the short run, a lot of skepticism about the inflation outlook. All of those things, as they get resolved—and resolved in a favorable direction—will help belie those pessimistic outlooks for interest rates.

We also have the major problem of the budgetary deficit looming out there. If that problem is not dealt with, then the risks of precisely the scenario that you're talking about seem to be very high. Those risks are essentially in your hands. If we can begin to get that budgetary risk out of the way, then I think it is quite possible to have a recovery, a sustained recovery, in the context of declining interest rates.

Senator PROXMIRE. Unless we do something about fiscal policy, unless we have an effective way of reducing the deficits, then the prospect of a sustainable recovery are not good?

Mr. VOLCKER. That is correct. I think, then, you would have to count on such an extraordinary increase in savings it would clearly not be prudent to contemplate.

Senator PROXMIRE. You talk about improvement of a permanent character in productivity and particularly in manufacturing. I just can't see that at all, for the life of me. I have the figures here and the figures show in 1981 we had a steadily declining productivity. In the second quarter it was 1.4, in the third quarter it was minus 1.6, in the fourth quarter it was minus 7.2, and in manufacturing even worse. In manufacturing we had a decline of something like 11 percent in productivity at an annual rate in the fourth quarter.

Where do you see this permanent improvement? There are give-backs, sure, and maybe they are encouraging, but they are give-backs because of the savage effects of recession. People are desperate. In order to hold on to their job they are willing to give up pay increases or even take pay cuts, but that certainly isn't going to continue. That's not permanent. I think you would have to agree that's not permanent. I would think as soon as we begin to recover there would be a very strong sentiment to recover some of those give-backs.

Mr. VOLCKER. I'm not so pessimistic, if we recover in the right way. The productivity figures that you referred to are the dismal record of the past. You can go back to the midseventies or before and show declining rates of productivity that aren't affected by cyclical problems. You have to look at those data with rose-colored glasses, I guess, to see a 1-percent trend as improvement in productivity during this period compared to what we used to think of as the normal 2.5 to 3 percent. The latest figures that you cite are the immediate reflection of the recession.

When you've got a sharp decline in production, that's what happens. What I'm looking toward is the upswing. You would see in the early stages of an upswing presumably sharp increases in productivity that aren't lasting either; they are just the inverse of the decline that you cited. But what I sense—and I can't prove this in the numbers; you can only prove it after the fact—apart from the examples that you can cite of wage give-backs and freezes and so forth under extreme pressure, is something going on in this area beyond what's reflected in the wage packages themselves.

Senator PROXMIRE. What? What's some hard evidence?

Mr. VOLCKER. You ask for hard evidence.

Senator PROXMIRE. What is the soft evidence then—the evidence?

WORK PRACTICES

Mr. VOLCKER. I can't give you evidence in numbers because it's obviously not there amidst the recession, but I get a good number of reports from businessmen and labor leaders about changes in work practices, for instance, in a very specific way.

Senator PROXMIRE. Can you give us an example?

Mr. VOLCKER. I know a number of company executives will tell me that they are quite satisfied in such things as the type of worker that has to do a particular job and can't do another job, that they've gotten considerable relaxation of that kind of a restriction, so there's much more flexibility in using their labor force.

Senator PROXMIRE. Isn't that exactly the kind of response you tend to get in a recession when workers are desperate, when they see the layoffs coming up and they are willing to share the work and make sacrifices to keep their job and it won't continue?

Mr. VOLCKER. That's the question, whether it will continue.

Senator PROXMIRE. It never has before.

Mr. VOLCKER. I don't want to limit it to that labor negotiation context. I think the businessman, under the same pressures that you're talking about, is having to look at his own operations and his own methods of production entirely apart from labor, and there's much more concentration on efficiency and productivity now, I suspect, in many industries, than there was a couple years ago.

I can't give you statistical evidence for that, but the crucial question is precisely the one that you posed: Will that continue during a period of recovery?

I don't think memories of this period are going to disappear right away for one thing, but let me also point out that when we get increases in productivity, and when we see the fruits of some of the things being done now, we will see a payoff; we should see a payoff.

I'm excluding another explosion in oil prices and a terrible crop year and this kind of thing. You would expect to see a payoff from that kind of measure in higher real incomes, in a lower inflation rate relative to the rate of nominal wage increase. As people see that, as they see their real incomes rising, really for the first time in a good many years, I think you will have a climate where you cannot see that kind of development disappear with the first breath of recovery, but where it will continue; I think you can point to episodes in the past where that is true.

If you can maintain a disciplined recovery, if there's a sense of discipline in national financial policies, then I think there is that prospect. If there's not that prospect, you're telling me that our economic problem is insoluble.

Senator PROXMIRE. My time is up, Mr. Chairman.

Mr. VOLCKER. I don't think it is insoluble.

The CHAIRMAN. Senator Lugar.

Senator LUGAR. Chairman Volcker, try to think through with me why any recovery ought to come at all. The thing that strikes me is that maybe I'm taking a look at it in a very parochial sense of the

State of Indiana, but I think it has some of the characteristics that are common to the whole problem in which the automobile industry has been in a recession for at least 2 years, unemployment has been substantial, and there are predictions that maybe 100,000 people will never return to the industry, not all of them in Indiana, but a good amount of permanent displacement. The agriculture implement industry, which is large in our State, is similarly afflicted for different reasons, partly because farmers have had a decline in income and are not buying additional machinery. There is weakness even in land prices. There are some estimates of maybe a 4-percent decrease across the board in land prices after a very sharp escalation, and I think in your testimony you pointed out that this is also true in the homebuilding area and in residences. But it would appear that residential values are declining but this decline is not showing up as yet, for various reasons, in the cost of living indexes. In part they do, but not perhaps as substantially as the real declines in value.

The steel industry is weak because of international competition, the modernization problems, and less demand for steel, whether it be automobiles, agricultural implements or a lot of other situations and, in short, the government of the State of Indiana has a revenue problem, as does the Federal Government, because individual incomes and corporate incomes are all declining precipitously.

But there is not in that picture any reason why that is going to change. Now the thing that I look at with amazement are bland predictions that the second quarter will be a warming trend and the third quarter will be better still, and I don't see any evidence at all as to why this might be so. As a matter of fact, I see a larger deficit in Indiana and therefore, because we can't have a deficit, really savage declines in services will occur.

In the Federal case where we can have a deficit larger—quite apart from what we do in Congress—I think we are going to cut spending, but I don't see any prospects for increased revenue, and that means we may have even larger deficits just through declining productivity.

It's for this reason that some persons have suggested, for example, as opposed to forgetting the individual tax cut in July, that we ought to accelerate that. Some have suggested, as a matter of fact, that if that is not a good idea, we ought to think at least of a substitute because the promised recovery appears to be linked in part to new revenues coming from consumer activity after that tax cut of July 1. I'm not certain that that will make a large difference in my State. It may make a difference in the country as a whole, even when the tax cut comes, given this decreased productivity.

This is why I proposed what I did earlier on in the sense that I think that some type of responsible or more immediate stimulus is required. I would not argue at all that in the long-term rates investors are taking a look at the future and what they want to risk. In the short-term situation, it seems to me to be one in which either we'll have a breakout through a very small window of opportunity or we could sink into a good bit of despair that leads to all sorts of options that are undesirable.

In other words, I would think after a while that what Senator Proxmire discussed in his scenario might turn out to be true, that

interest rates might continually rise, that unemployment might continually rise, that income might be falling, and that without a new game plan or at least some semblance of that, there are no breaks in sight.

Can you comment on that generally and why you see any potential for a turnaround and, if you don't, what you advise us to do?

POTENTIAL TURNAROUND

Mr. VOLCKER. I do see that potential, and let me offer you some rays of hope, or more. We are partly in a normal—if that's the right word—recession pattern. I don't think, as I said before, that this situation is just a "normal recession," but it has some of those characteristics. What you have seen recently are very sharp drops in production. The automobile industry is a good example. They have depressed levels of sales, but, in fact, production levels are below sales levels. That's true in a number of industries, so you're beginning to see declines in inventories.

You get a normal reaction to that if the assumption holds up even reasonably well in a rebounding production which, in turn, generates some income. You've got two industries that you cited in particular, the automobile industry and housing, both of which have problems of their own that are beyond interest rates, particularly the automobile industry, which has been in a depressed state for a couple of years. You could well have a situation where you had some recovery in automobile sales; the most recent figures show some—they may not last—but you could have a recovery, if recovery is the right word for inadequate levels of automobile sales historically. You could go above the current level and well above the production level, and that brings increases in production in a normal recovery pattern. That's a dramatic example, but you could see the same thing in other industries.

You asked whether consumption is going to be maintained. The Government, as things stand, is running a very large deficit which directly and indirectly supports income and consumption. You referred to the tax cut on the horizon which will amplify that in the second half of the year and provide support for consumption and reinforce the view that there can be and will be economic recovery; that is our general expectation.

If you ask me whether there are any hazards in that prospect, of course there are. The major hazards revolve around the conditions and prospects in financial markets, and that is why I keep coming back a lot to the same point: What you do with the budget has, perhaps as much as anything else, to do with that prospect in the financial markets. It is important not only during the period when you will be actually affecting the budget, but it also feeds back directly into financial market conditions. The most dramatic thing that can be done and the most effective thing that can be done in terms of the financial uncertainties that exist is for you to give the right signal as soon as you can about the budgetary problem.

Senator LUGAR. How much of a signal is required? In other words, when you talk about doing the right thing, clearly now we have as a target $91 billion of deficit the President has suggested.

What should the deficit be and what kind of a signal would be encouraging to people?

Mr. VOLCKER. I've said repeatedly I would feel much more comfortable with, and I really think you should aim for, a lower deficit in 1983; and I think you really have to have your mind on 1984 as well.

Senator LUGAR. How much lower, though?

Mr. VOLCKER. If anything, I think the basic budgetary situation has deteriorated from what I thought it was 6 months ago. You have a $100 billion plus problem for fiscal year 1984, and I would think it is definitely important at this point to put the deficit so firmly on a declining trend that you could reasonably look forward to balancing it in a reasonably prosperous year. That's a large amount of action, and I think that's a size and measure of the challenge. You put together that kind of program and I think it would have an electrifying effect on financial markets.

Senator LUGAR. But you're talking now about a program without specifying figures. You've left the $91 billion alone in 1983 and you said something less than $100 billion in 1984.

Mr. VOLCKER. The President's program adds up to about $83 billion for 1984, so I'm saying I would recommend to you to go another $20 billion or more.

Senator LUGAR. But that you have to have a program that comes out balanced at some point in the future?

Mr. VOLCKER. Yes. You won't balance it in 1984, but a program assuming a steady, healthy recovery, that would be consistent with restoring balance. Obviously, it would require some action thereafter. It would be consistent, in my judgment, with restoring a rough balance, when the unemployment rate got down to 6 percent or a little lower.

Senator LUGAR. In this particular year's term, your judgment is that through inventory reductions in the classic way we move through recessions, we are going to come to a point at some stage in which we begin to turn around and that is the engine of bringing us out of it?

Mr. VOLCKER. It's not just the inventory reduction; it's that plus the income support that the budget has already provided, plus the additional income support that the budget will provide at midyear. The key question is the extent to which the financial markets—you emphasized that—clear up. Again, coming back to the kind of scenario that Senator Proxmire set forth and that you raised a question about, completely consistent with our monetary intentions, you would expect that if the economy began to be anything like that weak you would get a lot of easing in the money markets simply because there would be much more money per dollar of GNP. That easing in the money market would counteract the depressing effects, and your scenario would not build on itself unless something very fundamental went on in the relationship between money and the economy.

If something that fundamental went on, which I wouldn't expect, obviously we would come back and look at our targets.

Senator LUGAR. My time is up, but I think that's very important—what you have said—that is, if that scenario does follow, you're prepared to take a look at the targets and at change?

Mr. VOLCKER. I really don't expect the scenario of a fundamental change in the relationship between money and the economy to develop.

Senator LUGAR. Thank you.

The CHAIRMAN. Gentlemen, before I call on the next Senator, I would like to explain the policy again for members of the committee that I have adopted, which is to call on Senators on both sides of the aisle on the basis of when they were here. So although Senator Cranston is senior, Senator Riegle has been here since the beginning and I would call on Senator Riegle unless you two want to arm wrestle for the next position, and then Senator Dixon would be next, having been here from the beginning as well on that side. So that's my policy. If you gentlemen want to do it differently, fine.

Senator RIEGLE. I appreciate the chairman clarifying that. Let me just ask another question because I would like to find a way to accommodate my colleagues who have other committees and just arrived and haven't had a chance yet to speak or ask questions.

The CHAIRMAN. You haven't had an opportunity to ask questions yet either.

Senator RIEGLE. No, I have not questioned yet, although I was able to make a statement.

The CHAIRMAN. You can do it any way you want to. I just prefer to do it that way. Both you and Senator Dixon have been here since the beginning and I want to accommodate you.

Senator RIEGLE. Let me say both to Senator Cranston—we have 10-minute slots. Let me say to both Senator Cranston and Senator Sarbanes, if either one would like to make an initial comment on my time, they are welcome to do so, while in terms of questioning I would like to reserve what's left.

The CHAIRMAN. Just don't use all your 10 minutes deciding who's going to go next.

Senator CRANSTON. I have to be somewhere at 12 and I'd like to get one question in before I go. If you will take care of me in that way, Mr. Chairman, I will patiently wait. I think it's much fairer to go the way you want to go. I have a lot of questions, but there's one question that I wanted to be sure to ask today.

As Senator Garn referred to election year pressures when the Fed might be persuadable to ease the tight money momentarily, there's been a lot of uncertainty as to the responsiveness of the Federal Reserve Board historically and potentially now or in the recent months to an administration that may want something different from what the Fed is doing.

How responsive is the Fed in election years or election months and not in election months to the views of an administration when those views are different from the views of what the Fed feels should be done in monetary policy?

Mr. VOLCKER. I think you will find the unanimous feeling in the Federal Reserve that the Congress deliberately set us up with an insulation from that kind of political pressure, and that that is a trust that you have given us and that we mean to discharge.

Senator CRANSTON. So, in effect, you're saying that in times of election and in times when we're fairly far away from elections, the Fed will exercise its own independent judgment on what it

should do in regard to the money supply and other policy decisions that the Fed has responsibility or power to make?

Mr. VOLCKER. Yes, sir.

Senator CRANSTON. Thank you very much.

Senator RIEGLE. Mr. Chairman, let me quickly ask you some questions and then I will defer to my colleague from Maryland.

This is a serious question and so I would like you to try to give us a serious answer, as difficult as it may be. What, in your opinion, would have to happen in order for us to see interest rates to come down 2 or 3 percentage points in the next 90 days or perhaps even more than that, but at least that much?

BUDGET KEY TO REDUCTION OF INTEREST RATES

Mr. VOLCKER. Dealing with the budgetary problem.

Senator RIEGLE. Your answer is deal with the budgetary problem?

Mr. VOLCKER. Yes, sir.

Senator RIEGLE. How much would it have to be dealt with, in your view, to get that kind of a response? I think the interest rates have to come down at least 2 or 3 percentage points within the next 90 days, and you're saying the budget is the key. We've got to take the next step in terms of defining more precisely what kinds of actions might be taken on the budget within the next 90 days that would give that kind of response.

Would you see us having to have a new budget? If we passed the budget we have here before us, will that get the job done in your view?

Mr. VOLCKER. You're dealing in relationships that are not mechanical; they are a matter of great judgment. There's no numerical answer that I could give you that says each $20 billion of the budget deficit is worth *x* in interest rates. There's just no way I can make that kind of judgment.

I would say if Congress got together a dramatic package of the size that the administration proposed in numerical terms—and I recommended a bigger one to you—that in itself would have an impact, because there is a great deal of skepticism out there as to whether anything of that magnitude will be done.

Senator RIEGLE. If Congress, on a bipartisan basis—and presumably with the President being welcome to meet and work with all of us—could come up with a budget looking particularly to 1983 and 1984, which you stressed, which could get the deficits down to the level of the budget and hopefully $20 billion or more below that, as you said a moment ago——

Mr. VOLCKER. Right.

Senator RIEGLE. You think the response might well be a reduction of interest rates of 2 or 3 percentage points within the next 90 days?

Mr. VOLCKER. It could well be. That's a matter of judgment.

Senator RIEGLE. Is that your judgment?

Mr. VOLCKER. Talk to the market. My judgment is that you would have a dramatic influence in that direction, yes, sir.

Senator RIEGLE. So if we could pull that off, we could anticipate an almost immediate effect in response, at least within 90 days,

and you feel we would see a down trend in interest rates that we could count on? That's your best judgment?

Mr. VOLCKER. That is my judgment.

Senator RIEGLE. Well, I think that's an important point because then we ought to try to do that. I think it ought to be the mission of both parties and the President.

Now let me ask you this. When this budget was put together with these large deficits—there is a bipartisan consensus I think that they are too large that's clear now—and you tactfully today have said that you think they are too large and they need to be reduced, were you asked your opinion on this? Did the OMB or the administration ask you what you thought the impact would be on interest rates if budget deficits are the size they are in this budget?

Mr. VOLCKER. It wasn't put exactly the way you're putting it, but I offered my opinion.

Senator RIEGLE. Can you give us the same opinion?

Mr. VOLCKER. My opinion is the same privately as publicly.

Senator RIEGLE. So, in other words, the deficits need to be lower than what's in those documents? Mr. Volcker.

Mr. VOLCKER. I would like to see them lower, yes.

Senator RIEGLE. I have noticed that both Germany and England have eased upon their monetary policies just within the last couple weeks. Why is it that monetary policy is easing in Europe and not here?

Mr. VOLCKER. You're measuring "easing" in terms of some small changes they made in their discount rate, but their monetary growth may not be reflecting anything; I just want to make that distinction. They have taken action consistent with some decline in interest rates because the industrial world, generally, has the same kind of problems that we have in greater or lesser degree; they have had rising levels of unemployment and slow growth. The United Kingdom shows some signs of expansion, but it's pretty slow, and they had a couple of years of very large recession. The German economy, I think, shows some favorable signs in some directions, but they also have had rising levels of unemployment and excess capacity.

I might say that a limitation on their ability to have policies as expansionary as they might like, in their own judgment, is the pressure on their exchange rates and, in a sense, the international level of interest rates. In my contacts with foreign central bankers, they very strongly share the view that the most constructive thing we could do to help them and help the world economy is deal with our budgetary deficit.

Senator RIEGLE. Well, that may well be right. I just want to let you know I'm concerned about the fact that our interest rates are rising and theirs are dropping, and I think it's going to create other pressures on the trade side.

Well, let me just ask you another question quickly. If the tax cut were accelerated for 1982, which is being suggested, and brought forward in time—and you seem somewhat less concerned about the immediate year's deficit than the out-years' deficit—what effect would that have on monetary policy or your ability to operate at this time?

Mr. VOLCKER. I don't think it would have any real effect on monetary policy in terms of our targets. It might put a little more pressure on markets, but I really don't think the game is worth the stakes in the sense that it probably would raise more questions in the market and you might have an adverse psychological effect from the appearance of going in a different direction on the basic budgetary problem. We are in the month of February now and it takes a while to gear up in terms of withholding tables and all the rest, so I don't think it would be worth giving a confusing signal.

Senator RIEGLE. So if we were going to do that, it might have been well to do it 90 days ago rather than 60 days from now. It seems to me what you have said is very important in terms of how we can get a near-term improvement and lowering of interest rates—to summarize that we need a credible budget plan; we need to get the out-year deficits down measurably, by an amount larger than what's in the budget today; and it has to be real. People have to believe it. The financial markets have to believe it. I think that's a very constructive suggestion that you have made and we ought to do it and we ought to be deadly serious about it because the stakes we are playing with are not partisan stakes. I think what we are talking about are business firms that are failing in Utah just as they are failing in Michigan, and the prospect of giving people some realistic hope in this country that we can pull things together—but we are off course and if we don't have that kind of midcourse correction now in a serious way and to act a lot faster than the Congress normally does, we're not going to see the improvement in interest rates that's desperately needed at this time.

So I would hope that we could somehow, as a committee and as a Senate, start to move in a bipartisan way in that direction.

The CHAIRMAN. Thank you, Senator Riegle.

Gentlemen, we have a vote going on. I might suggest that I'd like to start moving over to vote on the floor of the Senate. I'm sure there are many more questions and we will come back. Senator Schmitt is next. He does not have time to come back, so I would turn the time to him until the halfway bell rings and I will leave, Mr. Chairman, and go over and vote so I can get back and we can continue the hearing.

Senator SCHMITT. Thank you, Mr. Chairman.

I'm somewhat more optimistic than some of my colleagues. I think the economy is going to do quite well this year as long as we don't get in the way and so long as we do follow the basic premise outlined in the President's budget message. The leading indicators seem to be turning upward in housing and inventories and productivity investments, as you have mentioned, Mr. Chairman. Inflation is decreasing, for the first time in recent recessions. We have had inflation going down instead of up during the recessionary period. Take-home pay for the vast majority of Americans who are working has increased because the value of that pay has increased because of the reduction in inflation and the stabilization of tax rates.

Maybe more importantly, the American people, according to all survey information, seem to be very much with the President and willing to be patient in seeing that we get economic recovery.

As to the Fed's efforts, I compliment you and the Fed, Mr. Chairman, for what you're trying to do.

My main arguments are, as some others have mentioned, in your ability to fine-tune what you're trying to do and the technical capability that the Fed has to fine-tune. Is there anything that we could do quickly to enhance your capability to hit the monetary aggregates? I want you to err on the lower side. I'm not one of these that want you to err on the upper side. But you have to admit there have been some violent swings in money supply growth, and is there anything we can do in the short term to help you manage those aggregates?

RESERVE REQUIREMENTS ON MMF'S

Mr. VOLCKER. If you wanted to pass a law rationalizing the system of reserve requirements, putting reserve requirements on transaction balances or money market funds and some other technical things of that sort, it would help, yes. I would like to see reserve requirements on the money market funds, but I wouldn't put great priority on the others, and I couldn't urge you to make it a piece of emergency legislation because I don't think it makes that much difference.

You referred to the instability. Let me return to the point that I made to Senator Garn. I think it would be useful to go on the record via a letter to him, but I can give you monthly or quarterly figures for fluctuations in other countries. Canada had a monthly annual rate of minus 40 percent one month and plus 80 percent in another, an annual rate that's far in excess of anything we had. France went from a miniscule minus 6.5 percent in one month to plus 36 percent in another month. Germany went from a minus 32 percent annual rate in one month to a plus 28 percent in another month. Japan went from minus 44 percent in one month to plus 93 percent—both annual rates—in another month, and similarly quarterly. I don't want to suggest that we're going to answer any of our fundamental problems by achieving stability month to month in the money supply or that that's necessarily desirable to that extent.

Senator SCHMITT. Mr. Chairman, you've made an important point about what you see as investments in productivity so when recovery occurs it's going to occur with the potential for increased productivity in a number of industries.

Do you see that there's a danger that that might be temporary based on the longer term investments in new technologies that the Government and the private sector are making, or are not making which tends to be more of the problem today in this budgetary system?

Mr. VOLCKER. I certainly am not an expert on the expenditure side of the budget and what it does to support research and technology and so forth, and I really can't comment in that area because I don't have enough expertise. But in terms of a general fiscal strategy on the tax side as well as on the expenditure side, it's obviously helpful and useful to take into account and stimulate those things that do encourage investment, research, technological

change and all the rest, and, of course, that was the basic rationale for the tax bill passed last year.

Senator SCHMITT. Mr. Chairman, I hope that we won't do anything for very long anyway that jeopardizes our ability to sustain an economic recovery. Certainly I don't want you to let the money supply grow too fast because that is what makes deficits inflationary, as I indicated earlier, and I also hope that the administration and the Congress will not do anything to seriously deplete the reservoir of new science and technology that must always be rejuvenated if we are going to sustain an economic system in our particular type of political system.

There may be other types of political systems, but I find them unacceptable and I think the vast majority of Americans find them unacceptable, and certainly the vast majority of people in the world who wish to have freedom in their future would find them unacceptable.

Mr. VOLCKER. I think your premise is fundamentally important. We want a recovery that's consistent with inflation going down. We can try to pump up the economy in the short run, but surely what we learned in the past is that recovery isn't going to last very long; it's going to last less and less long, because the markets are more and more sensitive to precisely that kind of policy, and they think a game is being played, and they are going to react to what they see as the long-run prospect rather than the short-run effect.

Senator SCHMITT. Thank you, Mr. Chairman. Hang in there and we will recess briefly for the vote and Senator Garn will return.

[Recess.]

The CHAIRMAN. The committee will come to order.

With all the difficulties you have, Mr. Chairman, you don't get summoned by lights and bells. I start to feel like Pavlov's dog and start to salivate when we hear all the noise.

WEEKLY STATEMENT

While all the rest of the committee members are returning, I might go back to what we were discussing earlier and you were attempting to answer about weekly reporting, and perhaps in our discussions about that maybe we focused it too narrowly and maybe it isn't just an issue of weekly reporting but whether or not the weekly statement is adequate.

There simply hasn't been, in my opinion, if you do go with the weekly statement, enough expansion of it and enough explanation of it. Currently, the Fed statement gives only movement in the money supply figures and other bank data, but does not contain any analysis or statement of the Fed's interpretation of the data as it relates to, as an example, the preceding 4 weeks data, an estimate of potential noise and confusion in weekly data money supply figures for the year, and so I'm wondering if you would comment not only as you were starting to about the frequency, but if we do continue with weekly statements, some further explanation might dampen those ups and downs.

Mr. VOLCKER. Let me respond to that very directly. In the context of your question, I'm interpreting you to mean putting it in

the right statistical perspective rather than trying to explain why last week's figure went up or down.

The CHAIRMAN. Within that context. In other words, rather than just here is a weekly figure.

Mr. VOLCKER. A very fair question, which I scratch my head about. We have made some changes; I think it's fair to say we will make additional changes—and maybe we should have made them sooner—precisely so as to publish the figures in a little longer perspective.

The reason I suppose we haven't done that more aggressively is innate skepticism on the part of many of us, that no matter what perspective we try to put it in statistically, the headline in the New York Times and the Washington Post on Saturday morning will be, "The money supply dropped or rose $x$ billion dollars last week." They will never look at the moving average or anything else.

Some of them do attempt to put it in a little more perspective. But we can probably do a better job—I would hope we could do a better job—in trying to do that kind of thing. We have thought about putting a footnote on the thing, putting on a warning like on a cigarette package, saying, "Taking these figures too seriously on a weekly basis may be dangerous to your health." We have, as you know, provided a lot of analysis, in statisticians' terms, about the amount of noise on a weekly basis or on a monthly basis. Reciting from memory, it's plus or minus $3 billion which is the statistical test of being meaningless in any particular week. Obviously, the figures are useful when they are accumulated steadily over a period of weeks, and that's what we try to watch out for. From necessity, I think the market—the sophisticated people in the market—realize that and they tend not to react weekly, but you're never quite sure when they are going to react. Sometimes you will print a big figure and they will say, "Maybe that's an aberration," and there isn't much reaction, particularly if it interrupts a quiescent trend; and then they will react later on because they are disappointed that it wasn't reversed right away or whatever.

I think they try to make intelligent judgments, but there is a real problem when so much hangs on one figure which has its own statistical vagaries.

One of the real problems with publishing a figure weekly—whether it's department store sales or the money supply or automobile sales or anything else—is that a weekly seasonal is almost impossible to compute in a reliable way. It's got statistical properties that mean that any weekly seasonal adjustment factor is not very good, not very stable from year to year, essentially because the weeks end up in a different part of the month every year. If you didn't publish a weekly figure, you would avoid that statistical problem of the inherent noise in a weekly series. We have felt—not as a final judgment—that if we don't publish them weekly a certain burden of proof falls on us as to why not. Legally, in terms of the Freedom of Information Act, we collect the figures and so the burden of proof is on us to publish them. And, of course, it is pressed upon us by many people in the market that any scrap of information they can get—and sometimes I think however irrelevant, but that's an ungenerous comment—enables them to provide a more efficient marketplace, that if they know everything that is

possible to be known, the market will perform better. That's a normal presumption of an economist; I don't know whether it's always true, but that's a common presumption.

The CHAIRMAN. I understand the pressures to report it weekly and if you were collecting the data obviously there's an obligation to report it, and the next question I think that is logical is, why collect it? And I recognize there are plenty of private organizations who would run around and call the banks and ask for the figures and try and have it unofficial. I can't imagine that those unofficial reports would have the impact of the reports the Fed did.

So, as you have stated very clearly it's very difficult to report accurately weekly figures, why not go the next step and not collect it on a weekly basis? Then you can't be criticized for not reporting it and do it on a monthly basis, and if private individuals want to run around guessing, let them.

Mr. VOLCKER. You're about at the point in your thinking where I am in mine. I, at least, wonder whether we should collect all these figures weekly. As you can imagine, there's a certain amount of tension between the desire not to collect them weekly and our natural curiosity about what's going on in the course of a month too. If we did adopt the kind of contemporaneous reserve accounting approach that we ourselves propose there might be some logic in collecting figures every 2 weeks; it is a 2-week reserve averaging period that is proposed and, as you know, there would be, perhaps, some natural conformity there—maybe it's a halfway house. Whether it's a satisfactory one or not, I don't know. At least our preliminary considerations suggest we should not go so far as to have a reserve averaging period only once a month, which would be the logical accompaniment to collecting the figures once a month, but which potentially creates other problems.

The CHAIRMAN. I understand, but it seems to me if we, some way, whether it's 2 weeks, whether it's a month—if a weekly average sends signals to the market, which it obviously does, it certainly will hear about it every week from all sorts of sources that are inaccurate. Why, with all of the difficulties in the market, are we publishing inaccurate figures and not changing that process?

Mr. VOLCKER. I think it's fair to say the concentration on these figures—not just in the United States but around the world—is a symptom of the uncertainty the markets feel. They want to find this out. They haven't anything else to cling to. They should wonder about deficits and inflation and all the rest, this should be fundamental to the market in the midst of all this, and they cling to something that may give some direction in the next few days.

The CHAIRMAN. How is that logical to make business and investment decisions on a figure that is inaccurate? I just don't understand that at all, that they are so anxious for something that they will take what they know is probably wrong rather than waiting another week.

Mr. VOLCKER. All I can say is they are a little bit better with them than without them. We have canvassed them and we have talked with a good many people. Interestingly enough, those who have commented on publishing the weekly figures are split pro and con 50-50. About 50 percent of the commentators said, "Oh, it would be a terrible thing to stop publishing them weekly." That

comment tends to come more from the technically oriented people and the marketing people. The other half have a variety of suggestions. It's not that 50 percent suggest we do it weekly and 50 percent suggest we do it monthly; it's around 50 percent suggesting we do it weekly, 10 percent suggesting we do it daily, 15 percent suggesting we do it without seasonal adjustment, and 20 percent suggesting we do it every 2 weeks. The opinion is very well split among consumers of the data.

The CHAIRMAN. Mr. Chairman, thank you. Unfortunately, there's another vote going on and I will have to leave. I would ask the staff when the first Senator appears, so we are not unduly delaying you and we can complete the hearing as expeditiously as possible—Senator Dixon's turn was next, but whichever Senator appears first after this vote, either Republican or Democrat, have them start the hearing and continue the questioning, and I will jog as rapidly as I can.

Senator Dixon, you're the temporary chairman. It's yours to do as you will until I get back.

Senator DIXON. That's an awesome responsibility, Mr. Chairman, and I will do my very best.

I want to thank you, Chairman Volcker, for being so patient with us while we are casting our votes. I have only three questions I'd like to ask you.

The first is this. You were talking earlier with Senator Lugar about the proper signal to send to the money market managers. I ask you in reference to what the President has suggested to us whether in your opinion anything we might do in connection with budgetary cuts within the framework of his budget will be adequate to send the right signal if we don't do anything at all on the revenue side and if, in fact, we do pass a military appropriations somewhere in the area of what he's suggested, which is approximately around 18 or 20 percent up for this fiscal year?

Mr. VOLCKER. You would have to give me the bottom line, I suppose, in terms of what cuts you could get; your judgment is going to be better than mine. If you can't do it in the proportions he's proposed or go beyond that, it would be more valuable, in my way of thinking—if you can't do it by the expenditure side—to do it on the revenue side.

Senator DIXON. I don't mean to put you in an embarrassing position. I wouldn't ever consider doing that with reference to the President's position vis-a-vis your own position, Mr. Chairman, but what I'm asking you is whether you envision a circumstance in which the cuts could be adequate here by the Congress to make the proper response regarding the budgetary deficits if we increase military spending at the rate suggested in this budget by the President, and if we don't do more on the revenue side? Now that is my question.

Mr. VOLCKER. I'll give you my practical judgment. I don't know what it's worth because you're better able to judge what Congress can do and cannot do. I would think it is very tough to do it solely on the expenditure side.

Senator DIXON. Well I would certainly be inclined to agree with you. I just came from the floor and——

Mr. VOLCKER. Even the President doesn't have it solely on the expenditure side.

Senator DIXON. I appreciate that fact, although I think there's a very large question about what part of that is——

Mr. VOLCKER. I agree. It's in your ballpark, not mine, but I can say I have a good deal of skepticism as to whether you can do it on the spending side and, therefore, I think you need some revenue measures and you need revenue measures beyond what he's proposed.

FREEZE ON ENTITLEMENTS

Senator DIXON. I just came from the floor where I was visiting with a colleague, the Senator from South Carolina, Senator Fritz Hollings. There's been a considerable amount of publicity in the country concerning his discussion on the floor of the U.S. Senate yesterday and his suggestions about what we might do. It's simplistic in nature and, again, to even oversimplify what he's already suggested, I would be interested in your comments concerning his suggestion about a freeze, particularly in the entitlements, something on the revenue side, some adjustment in the budgetary area of the military, which I think in his case is—I don't have the figure in front of me—I believe it would have been a deficit of somewhere in the $44 or $45 billion area as distinguished from the even rosy figures the administration indicated of $91.5 billion.

Mr. VOLCKER. By some strange coincidence, a number of the members of the press were interested in my response to that question while you were out, and I can only tell you what I told them.

I have seen some reference to that plan. I read all of two paragraphs about it, I think, in the paper, and I really can't comment on the composition and nature of the plan.

To the extent that it is an aggressive attack on the deficit—and I can't comment on either the realism or the appropriateness of the components—I welcome it and I take it that's what it's designed to be.

Senator DIXON. In other words, your bottom line here, what you're telling this committee, is that without any regard to who is the author of the idea, you suggest very substantial intrusions upon the outstanding budgetary deficit, particularly in the outyears, is manifestly important if we're going to get the right response from the money market managers on interest rates?

Mr. VOLCKER. That is exactly what I'm saying.

Senator DIXON. One final question and then I'll yield to my colleague from Michigan.

Last year, Mr. Chairman, on one occasion, we had the Secretary of the Treasury, Mr. Regan, here, and in the course of some questioning I was carrying on with him at that time we discussed the prime. May I first ask, am I correct, the prime is 16.5 percent today?

Mr. VOLCKER. Yes.

Senator DIXON. We were discussing the prime rate and I asked him at that time whether he saw any light at the end of the tunnel and his response was, "Yes, and it's not a speeding train," but, of course, he was wrong, Mr. Chairman. It was a speeding train.

I'm wondering whether in this year, as a message to the folks back home, those many groups who talk to us—the farmers, the thrifts, the auto people, the housing industry, the appliance dealers, every merchant really on Main Street—whether you can suggest if we do the responsible things budgetarily this year whether you would see in perhaps the third or fourth quarters light at the end of the tunnel?

Mr. VOLCKER. Yes, and you put on the qualification that I put on it. You ought to direct your actions—in a larger sense, all of us can be directing our actions—toward the kind of economy and the kind of psychology that will reduce these extraordinarily high levels of interest rates. I think that's what we're trying to do. If you move in that direction, you lay the groundwork not only for a period of a few weeks, let's say, but for continuing movement in the right trend, by dealing with the inflationary problem and dealing with the budgetary problem. Between us, I think that's what we should be trying to do, and that's where the effort must be directed or it's not going to be successful.

Senator DIXON. Thank you very much, Mr. Chairman.

Senator Riegle, I was annointed with the responsibility of being chairman since I was the only one here, and having tasted of this heady wine, I now yield time to you.

Senator RIEGLE. Thank you. I think maybe we are getting somewhere today in this discussion in terms of how we work out of this bind we're in.

It seems to me what we've got to do is commit ourselves to both winning the long-term fight against inflation and high deficits, insufficient savings, investment and growth, and we have also got to do something about the short-term problem. We've got to do both of these things.

I think what you've heard around the table today is many of us—we're living in the first person with the short-term effects. We've got real disasters on our hands and they are spreading. So I hope the sense of urgency that you're picking up here today—and I assume in your other appearances—is linked to things that are happening in places we could take you so that you could see first hand what a tremendous toll is occurring both in terms of human damage and suffering as well as economic damage.

In terms of how we work our way out of it, it seems to me today that maybe it's possible to see a way. That is, that we have got to deal with the problem of these out-year deficits, bring them down. It seems to me we've got to have a bipartisan consensus to do that. You apparently were consulted when the budget was put together and it sounds to me as if you fought for lower deficits and didn't win. At least you were consulted. We were not consulted, those of us who were Democrats in Congress. We have not been part of that planning process. We would like to be in terms of sitting down now and reworking the numbers, reworking the fiscal plan and the out-year deficits, so we can, in turn, get this 2- to 3-percentage-point drop in interest rates over the next 90 days because that has to be the goal that we set ourselves to achieve, and at the same time work to achieve long-run goals that there's agreement on.

If we can make some progress with that idea, I take it that the Fed is willing to play whatever constructive part it can play if those dynamics are set in motion. Is that right?

Mr. VOLCKER. Yes. I think the constructive part we can play is laying the groundwork, increasing the confidence and building on the growing confidence that we will deal with this inflation problem, because the short-term plan is going to fail if there isn't that background.

TWO-STEP FISCAL PLAN

Senator RIEGLE. What if we were to do it in two steps? The hard part will be to move the machinery in a hurry, although I think we have to do that. Whatever we design has to be something that we can accomplish quickly rather than having it stretch out over a period of months. The Congress, for example, on a bipartisan basis and in cooperation with the administration, could work out a fiscal plan that gave us deficits that began to go down more sharply and a signal could go out to the financial markets that would in turn lead to a quick drop in short-term interest rates. I'm wondering if we could agree on the total numbers necessary and lock those in so that we had a fix on the deficit, and perhaps in the second stage—it might take another month or two—deal with the question of how you actually assign the spending priorities within those ceilings. In other words, by taking it in two steps, it wouldn't get paralyzed on the question of what the spending choices were per se. We would concentrate first on getting the aggregate numbers locked in place. It seems to me if we were to do that, if we were to set the overall spending levels to give us those deficits, a pattern of deficits that were lower and would work in terms of bringing down interest rates, perhaps that's the thing we should concentrate on now, trying to get that done within the next 30 days and in the next stage go ahead and work the details into place that would support the aggregate numbers already agreed on. I'm not saying that's a perfect approach, but as I try to think about what is the practical way to resolve this dilemma so we don't just end up with partisan bickering or with people throwing up their hands and saying that nothing can be done, that something of that sort needs to happen. And I believe that's the most logical way to approach it.

So if we would within the next 30 days get any kind of a momentum rolling here in a bipartisan consensus on overall fiscal numbers and lower deficits stretching out into the future, with a second stage effort to work out the details that would come within those spending ceiling figures, would it still be your view that the short-term interest rates would show an improvement in the next 90 days?

Mr. VOLCKER. You describe a process that may indeed be constructive. Just how the market would react in these interim periods, I don't know. It would react better than otherwise, but I don't think you've got a problem that you can solve by stating an expenditure goal. The market is very well aware that's been done in the past. You had an expenditure goal incorporated in the budgetary resolutions last year of $695 billion and the latest estimate is $725 billion and rising, and I don't think you can expect you're

going to revolutionize the world by stating a goal. That may well be an essential part of the process and a constructive part that you're talking about, but just how the market would take it, what degree of conviction they would receive it with, is going to depend on a lot of intangibles. That doesn't bear upon the reasonableness of the process that you're describing, but perhaps upon the difficulty of combating years of doubt in performance.

Senator RIEGLE. Well, I believe if there was a bipartisan aspect and both the legislative and the executive branch worked together on this, it would have a degree of credibility that it wouldn't have otherwise.

Mr. VOLCKER. Always.

Senator RIEGLE. That approach is the best one that I can see at the moment, and if we don't find one like that, it seems to me what we are left with is an impossible situation. Just looking at the calendar right now and the difficulty of working these basic dilemmas on through it is obvious that we are not going to get it done. We are not going to get it done in time and we are going to be faced with a situation where interest rates stay too high and in fact may even go higher, and we are not going to see an economic recovery of any consequence.

Mr. VOLCKER. I think the premise of your comments would not be the same as the premise of my comments. We are both talking in terms of probabilities. Nobody knows, but the probability seems to me that the economy is today somewhat stronger and less weak than you fear, but there are risks there. In saying that, I don't in any sense want to remove the sense of urgency that you feel, which seems to me terribly constructive, but I don't think we face the kind of hopeless situation in which we've got to have a magical result in the next month or the roof will fall in. Your sense of urgency seems to me entirely appropriate; your sense of extreme doom maybe is a bit overdone.

Senator RIEGLE. Well, you know, I look at you out there and what comes to my mind is that ad you see in the magazines that the insurance company puts out with the fellow sitting there and thinks everything is fine but a piano is just coming out of a 70-story building and is about to land on his head, and that's what's happening in the country. And you have heard it from people on both sides of the aisle.

Mr. VOLCKER. I understand your feeling very well. We are living in a period of uncertainty and there are very great risks out there. I can only tell you that I think there are somewhat, in a sense, at the bottom of every recession——

Senator RIEGLE. This one is different. You have to go back literally to the 1930's to find situations that are comparable to many that we see today. I'll tell you how serious it is. Although it didn't come up today, we've got serious people in Congress on both sides of the aisle that are now talking about restructuring the Fed, about changing the arrangements because of the impossibility of getting the interest rates to respond. That's how advanced this debate has become. We haven't gotten into that today because I like to talk about more immediate, practical things, but I don't think there's an immediate appreciation of the scale of the disaster that's building here.

Mr. VOLCKER. Let me say that I get around a bit. I don't feel as insulated as I'm sure that you fear I am or other members of the Board are. We have some very real sense, I think, of just the concerns that you have. We have a real sense of concern not only about what's going on, but about the possibilities of various hazards in the future. Our basic feeling is that we will have some recovery, and we think the entire weight of economic analysis, not our own but other people's, is in that direction. But I quite agree with you that the function of these hearings and other discussions is to focus on all those things to make the most favorable outcome more certain and the least favorable outcome less certain. There is just no question that we have identified and agreed upon a major hazard that has to be removed.

I can't be optimistic about the future if you're not going to take action on the budgetary side.

Senator RIEGLE. But the financial markets are voting "No" on this fiscal plan. This budget is stretching out into the future. In a nice way, you are voting "No" on it. You're saying you've got to get these deficits down further. All I'm saying is that to the extent that doesn't happen, we are not going to see things improve, and you're saying the same thing, and I'm saying time is running out.

Mr. VOLCKER. Exactly. I'm fully with you on that. Let's get to work on it.

The CHAIRMAN. Senator Proxmire.

REDUCTION OF INTEREST RATES

Senator PROXMIRE. While I was gone I understand that you indicated that if we could cut the deficit by $20 billion or so that would be very helpful to you and would result in a reduction in interest rates of 2 or 3 percent.

Mr. VOLCKER. I don't want a lot of weight put on a precise number.

Senator PROXMIRE. I know that.

Mr. VOLCKER. I'm formulating an order of magnitude. The $20 billion you refer to was a concept of $20 billion less than the President was proposing for 1984, which is more than $100 billion from where you now stand.

Senator PROXMIRE. The reason I suggest that is I have worked out a series of tax increases and spending reductions that would cut the budget by $30 billion in 1983 and far, far more in 1984 and 1985.

Mr. VOLCKER. All the better.

Senator PROXMIRE. As you know, any initiative we take this year has relatively little effect in 1983 compared to what it will have in the out-years, particularly with respect to confidence.

Mr. VOLCKER. All the better.

Senator PROXMIRE. Then I understand, as you may know, Senator Hollings has made a very interesting suggestion and one that has great simplicity. I couldn't support it, at least not in its present form, but maybe some modification of it. He suggests we freeze everything in 1983 at the 1982 level. In other words, no increase in social security, no increase in defense, no increase anywhere, have everybody make the same sacrifice. In other words, nominal ex-

penditures would be the same in 1983 as in 1982. He argues that this would actually balance the budget because it would result in a $100 billion reduction in the deficit, and I think it would be close to that if we could do it, but it seems to me almost impossible to do that in defense. In fact, in defense, we've got the contracts, you would have to repudiate contracts and at the same time pay a very large settlement when you did that, but at any rate, what do you think of that general notion of that attempt?

Mr. VOLCKER. I haven't had any chance to examine it. This came up while you were out, and I don't want to comment on the specifics of it, but I greatly respect and admire that kind of aggressive thinking about how to deal with this problem. I don't think I can make any comment on the specifics of the approach.

Senator PROXMIRE. Let me ask you this.

Mr. VOLCKER. If you've got a plan to do $30 billion more, let's get that on the table, too.

Senator PROXMIRE. You're the expert. If there is an expert, you're certainly it, on the interest rates and the monetary policy. What effect would the Hollings proposal have, in your judgment, on the credit markets if we could put something like that or approaching that into effect?

Mr. VOLCKER. It comes down to the bottom line. I assume that would have a very dramatic effect and, if it was considered realistic and attainable, would have the kind of effect that I indicated earlier to Senator Riegle. I think it would have a galvanizing effect on the markets, but I'm using to the assumption that this would be a marked and realistic movement in the right direction; I'm talking theory. I've not seen his particular proposals so I don't know whether they would be realistic. You raised some questions about them yourself, and some of those questions would immediately come to my mind. I have been through some of these budgetary exercises before on a smaller scale. They seemed big at the time, in earlier administrations; and freezing is harder to do than to say, for the reasons you suggested, because you get the problem of differential impacts on different sectors and so forth.

GROWTH RATE

Senator PROXMIRE. Now I understood or I heard what I thought was a very interesting and very necessary response that you gave the chairman to the argument that the volatility of the Fed has been responsible for high interest rates. I thought your response was very logical and especially when you compare it with performance of other countries. But I'd like to ask you about the failure of the Fed last year to come in with a growth rate, particularly in the first three quarters of the year, that was anywhere near its range. In 1981, the $M_{1}$- range was 3 to 5.5 percent. The actual growth was 1.3 percent. The $M_{1\text{-}B}$ was 3.5 to 6 percent and the growth was 2.3 percent. Why did the Fed miss its mark by such a big margin, particularly for three successive quarters? Nine months is a reasonably long time. Why were you so far below it and wasn't that really a factor in pushing us into a recession?

Mr. VOLCKER. That's a matter of judgment, but I can tell you generally how it came out the way it did. It was relatively low,

using the adjusted figures, for the first few months of the year, which, to say the least, did not disturb us because, as many have commented, it was high late last year and that was a period of declining interest rates, too, you may recall. Seeing a lull in money supply at that time was not in any sense a contradiction of what we wanted to see, both in terms of the earlier growth and in terms of what was going on in the markets.

Senator PROXMIRE. Except here you have a wide range of 3 to 5.5 percent and you were way below it.

Mr. VOLCKER. It's not wide——

Senator PROXMIRE. For quarter after quarter after quarter and, of course, as you say, at that time interest rates weren't rising, but with the lag involved, it seems to me you could make a strong case that the Fed was responsible for the sharp increases that came later and for choking off the recovery.

Mr. VOLCKER. I don't see it that way.

Senator PROXMIRE. And the recession we are now in.

Mr. VOLCKER. You say we have a wide range. The range isn't so wide in terms of the normal fluctuations. If you draw one of these conventional cones, the range is miniscule at the beginning of the year. You can't possibly be inside it. It's an unrealistic kind of picture to draw because by its nature it is infinitely small when it begins. As I recall, the previous year we ended up just at the high side of our range, a quarter percent above it I think. I drew pictures through the range for the next year from the high side of last year's range and said, "Well, let's leave ourselves some leeway below the very narrow, early part of the cone because we ended up higher last year and we like to see some decline, particularly in the context of declining interest rates." That was true at that time. Then we had a bulge in late March or April, as I recall. We sat on that pretty hard because we didn't want the trend to get out of hand. As the year progressed, we also observed two things which influenced our precise posture for the rest of the year. We observed week after week—it would have been the same month after month—this growth in money market funds which appeared to be influencing the trend of M1; and we also observed that M2, which is a much steadier figure I would note, was hovering around the upper side of the range all during that period. And some outside commentators at that time were putting more emphasis on M2 than M1. We put some emphasis on M2. So, taking a balanced view, considering that M2 was at the top of the range and some of the other aggregates, including M3, were showing rather rapid expansion, we were reasonably satisfied with the development.

I can't remember the date right now, but beginning in early summer, you will note that we consistently supplied more and more reserves to the market through our Open Market operations. In fact, short-term rates reached their peak either in late spring or early summer and, all during summer and fall—until mid-November or December when the money supply began rising more sharply—short-term rates were falling. We had looked at it in general. We announced to you in July that we would find it desirable to come in around the low end of the range. We would have been happy to see the money supply a little higher. We were tempted to push the $M_1$ money supply in terms of what was happening to the

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other aggregates, what was happening to credit generally: short-term rates were declining; interestingly enough, long-term rates were rising right through the end of September or early October, despite the decline in short-term rates.

I think this has a lot of bearing on the kind of economic problem we face. You have to speculate as to why long-term rates reached a new peak in September if that was the date when short-term rates had been declining for 3 or 4 months? That was a period, you will recall, of very considerable concerns about budgetary problems.

UNEMPLOYMENT UP—INFLATION DOWN

Senator PROXMIRE. Let me quickly, because I don't have much time, change the subject and ask you about the feeling on the part of many Americans that any success we've had in bringing down inflation can be attributed to increased unemployment. That's what's doing it and the references you made earlier to the improvements in productivity seem to be unemployment. Is unemployment the price, in your judgment, the Nation must pay to get inflation down and keep it down? Do we have to have unemployment at this level, 8.5 and 9.5 percent?

Mr. VOLCKER. I think there was always a substantial risk—I would stop short of inevitability—of economic dislocation, recession, when restrictive monetary policies and rather liberal budgetary policies came up against an entrenched inflationary rate, with the momentum of inflation, the momentum of wage increases, the unsatisfactory productivity trend. You can look back in my statements of 2 years ago; I consistently noted I did not think this was going to be a painless process and that the more that you relied upon monetary policy alone, the greater the risk of dislocations in the short run.

Having said that, we can't reduce the inflation on the backs of the unemployed for the future; that's an unsuccessful policy.

Senator PROXMIRE. A lot of people feel that's exactly what we're doing.

Mr. VOLCKER. They may feel that, but that's obviously not sustainable or appropriate. We have to get together a set of policies, a set of attitudes, that are consistent.

Senator PROXMIRE. Now what, above and beyond fiscal and monetary policy, both of which are designed to achieve their end by slowing the rate of growth in the economy, reaching out for incomes policy, for antitrust policy, for free trade and so forth, policies that will supplement and make it possible for us to do this with a lower rate of unemployment?

Mr. VOLCKER. All those policies are relevant. We tend to concentrate on monetary and fiscal policies. Those are the nice, big dramatic sounding Federal policies. They come in nice big packages and people love to discuss them. What you do in regulatory policy, what you do in free trade policy, what you do in competitive policy, is very important. I point out some of those things are not painless either. Competition from abroad brings pressure on industries.

Senator PROXMIRE. But we're not getting any real force from the administration on any of those policies, none of them.

Mr. VOLCKER. I won't respond to that comment. I think those elements of policy are terribly important and the way, in the end, to reconcile the growth and the lower levels of employment with the disinflation is that you build a different set of attitudes so that people restrain themselves, let's say, on excessive wage demands. That encourages productivity growth. It encourages cost restraint. It's not going to encourage you if you've got a record of 15 years of inflating and every time you run into a problem you inflate some more. Obviously, it's quite natural that nobody is going to respond in a way that's disinflationary then. You've got to build a whole different set of motivations. We have a whole generation growing up that's never seen price stability. It takes them a while to change their thinking. There have been references to housing prices leveling off or declining. Well, housing prices haven't leveled off or declined for who knows how many years. Housing prices increased twice as fast as the general inflation rate in the 1970's. Everybody thought it was great to commit themselves as far as they could on a house, or a bigger house, or a second house, because that was the way to beat inflation. If we don't have any inflation, it's not a way to beat inflation, but it does make your attitude toward home buying a little different. Eventually—you can see it very clearly in the homebuilders; there's quite a few I have visited recently who trying their best to build a house more cheaply, to build it more efficiently, to build it smaller—you have to change. We have had a great expansion in the size of houses in the last decade. You see great distress in Michigan and Ohio and other places where the auto industry is centered. They have many problems in that industry. It's a high wage industry. It should be a high wage industry; it's a tough job. The fact is, it's become, relatively, a much higher wage industry over the past 10 years. They have a competitive problem, and I think there's greater understanding of that.

The regulatory problem is part of it. Management attitudes, I'm sure, are part of it. This is all in the process of changing. That's where I'm expressing optimism. I really think it is in the process of changing and it is only through that kind of change that we will be successful in combining recovery with movement toward price stability. If there's no way of doing it, you're telling me, as I said before, that we've got an unsolvable problem in this country, and I don't think we've got an unsolvable problem.

The CHAIRMAN. Mr. Chairman, let me go back and follow up on what Senator Proxmire and others have said on fiscal policy and the major thrust of what you hear today in attempting to balance the budget. Everybody agrees, yes, we should have additional spending cuts, but also we should rescind parts, or in some cases, all of the tax cuts.

TRILLION DOLLAR DEFICIT

The question that I would ask you is, isn't the drag on the economy tremendous from carrying a trillion dollar deficit, even if we started to balance the budget immediately, the mere carrying of a trillion dollar debt—and also turning that over at roughly a one-third of it per year, refinancing it—a tremendous drag on the economy?

So my point is this: We could have balanced budgets by raising taxes. Certainly that is an option. At least it is my feeling, as much as I have always been in favor of balanced budgets—I'm not a new convert to balanced budgets like many in the Congress. I have supported balanced budget amendments in the past, constitutional amendments. But I would rather have an unbalanced budget at 18 or 19 percent of GNP in taxation than $1 trillion balanced budget at 26 or 27 percent of GNP.

So the question really, I suppose, is twofold. Isn't the debt a tremendous drag on the economy? It's still in competition for private sector capital. It's still creating shortage of money in the private sector and, in addition, if you want to balance the budget by increasing tax rates and absorb that much more out of the private sector, you could still have the tremendous dislocations, high-interest rates, and problems we see today, and we would all be saying we balanced the budget.

Now isn't it necessary to balance that budget with fiscal policy with a declining percentage of the national income being absorbed by government as well as expenditures, a balanced policy rather than just saying let's increase the load on the taxpayers once again and balance the budget?

Mr. VOLCKER. Strictly from the economic standpoint, I think you're better off balancing the budget in the context of declining expenditures and taxes relative to the rest of the economy, but that's not the end of the story. You mentioned the load of the existing debt. What stands out so dramatically in these new budgetary projections is the way a deficit feeds upon itself. When you get deficits of this size and then you have to pay the interest on it the next year, and the interest rates are above the inflation rate, you've just built a machine for making the deficits bigger and bigger and getting in a bigger hole. We have never quite been there before, partly because when interest rates were below the inflation rate it looked like a nice game. It doesn't look so good when the interest rate is above the inflation rate and the compounding of that interest, in itself, makes the budgetary problem that much harder next year and the following year and the following year. The degree of taxation you have to levy to pay the interest becomes a hazard in itself.

If you let this thing get out of control you're just going to be faced with a worse problem down the road. You say it's nicer to have smaller taxation at the expense of a higher deficit. The best thing—I'm sure we would agree—is to cut down the deficit and cut down the taxes and the spending at the same time.

The CHAIRMAN. Don't misunderstand what I said. I agree with what you just said. I said the choice between a very balanced budget at very high levels.

Mr. VOLCKER. I think that is certainly correct, but then you're left with the question that we're speaking of in economic terms. You've got to put in all those ingredients which you can make a judgment about and I can't; that you must make a judgment about how big the defense program should be and all the rest.

The CHAIRMAN. All I'm saying is we need a balanced approach in taxation and spending cuts and not just attempt to do it one way or another.

Mr. VOLCKER. Right.

The CHAIRMAN. Senator Sarbanes.

Senator SARBANES. Mr. Chairman, I understand that the policy you have been pursuing is, as you understand it, a policy which the administration wishes you to follow. Is that correct?

Mr. VOLCKER. The general thrust of the policy is, I think, supported by the administration. I would note that we started before this particular administration came into office.

Senator SARBANES. But this administration's position, as you understand it, is that you're pursuing the policy lines which they think you should be pursuing?

Mr. VOLCKER. In general terms, yes.

Senator SARBANES. When did you last meet with President Reagan to discuss economic policy, substantively discuss economic policy?

Mr. VOLCKER. In December.

Senator SARBANES. This past December. And that discussion, I take it, included the question of the policy the Fed should be following?

Mr. VOLCKER. Yes. There was no extended discussion of that. As I recall, we discussed budgetary problems probably more than monetary policy.

Senator SARBANES. Had you met with the President periodically prior to that understanding that the Fed is independent, with respect to the question of coordinating monetary and fiscal policy?

Mr. VOLCKER. We have met from time to time.

Senator SARBANES. What do you understand the relationship to be between the money supply and the interest rates?

Mr. VOLCKER. Complex. If you have a stable expectation in economic terms, it's a simple demand-and-supply analysis. If you push up the money supply, you would expect short-term interest rates to come down, at least for a while. If the money supply increases because the impetus comes from the demand side, you expect interest rates to go up. You have to look at where the impetus comes from. That's a very static analysis. You also have to look at what the further consequences are of the change in the money supply; if the ultimate influence is inflationary you get a different answer.

What we have today is not, obviously, a very stable situation within the economy or with respect to inflation, and we run a considerable risk—to understate it—that a policy of expanding the money supply that is interpreted as inflationary will increase interest rates and particularly long-term rates.

Senator SARBANES. So you would say that today, in order to get interest rates down, you should diminish the money supply. Is that right?

Mr. VOLCKER. I think in some circumstances you could argue, if that were your single-minded intention, that you would decrease the money supply. Now you carry that to a ridiculous——

Senator SARBANES. Are you, in effect, telling us that you really don't know how to get the interest rates down?

Mr. VOLCKER. I don't know how to get the interest rates down by manipulating the money supply over the next 3 weeks or 3 months, that is true; I don't think that's possible. I know how to get interest

rates down ultimately. I don't know how to manipulate them in the short run.

Senator SARBANES. Jim Tobin in testimony before the Congress said that when interest sensitive investments are discouraged—that would obviously be autos and housing, among others—workers lose jobs and wages; businesses lose sales and profits; governments lose revenues but acquire new spending obligations. The Federal deficit is higher, witness the sudden drastic upward revision of the estimates once the administration acknowledged the recession.

Now isn't it a fact that the high-interest rates which have provoked the downturn in economic activity in certain sectors of the economy which causes people to be laid off and businesses either to go bankrupt or to suffer losses, has helped to contribute to the increase in the size of the deficit?

Mr. VOLCKER. If you look at the 1982 deficit, yes, it's got a cyclical component that moves that deficit up, whatever the cause of it.

Senator SARBANES. Did the high-interest rates help to contribute to that cyclical component?

DEFICIT DURING RECOVERY

Mr. VOLCKER. In an immediate sense, yes, but you have to look beyond what caused the high-interest rates to what the situation in the economy was generally. I'm not referring, I might point out, to the harm of the deficit this year. What does concern me is not the point you have just made or that Professor Tobin has made. The prospect is that the deficit will increase and increase, substantially, during a period of recovery. That is what is unique about this situation.

Senator SARBANES. Well, now, were you supportive of the President's budget proposals last year?

Mr. VOLCKER. I repeatedly expressed reservations about the combination of tax cuts and expenditure plans, and I could submit for the record, if you like—the question came up yesterday—some of the comments I made earlier and my concerns about the possibility of congestion in markets and the damage to investment incentives if the budgetary consequences and the tax reductions were not recognized on the spending side or otherwise. I can quote some of my statements to you if you would like.

Senator SARBANES. This movement toward a tighter fiscal policy—from your perspective in reacting with monetary policy, does it matter much to you how a tighter fiscal policy is achieved?

Mr. VOLCKER. It matters as a second approximation, I suppose. The first thing I would focus on is what the relationship is between expenditures and revenues, assuming good business conditions——

Senator SARBANES. I was very interested in an assumption with Senator Proxmire. You were talking about what's going to happen in the future, about the inflation rate coming down, and getting a sustained period of recovery and you said then, assuming that we did not have a problem with energy sources, or bad weather for crops—and we have been fortunate in those two areas. Obviously, those are two major components of your Consumer Price Index and one of the reasons that we have been getting a fairly good perform-

ance on inflation has been our good fortune in those two areas. Is that not the case?

Mr. VOLCKER. Yes; I don't think the movement of energy prices and food prices is entirely uninfluenced by other policies, but it's certainly true that——

Senator SARBANES. Is it influenced by your high-interest rates?

Mr. VOLCKER. In the short run, yes.

Senator SARBANES. By provoking a recession?

Mr. VOLCKER. No, by, among other things, provoking oil companies not to hold excessive inventories, for instance.

Senator SARBANES. How about on the food side?

Mr. VOLCKER. On the food side, I think it would be less true apart from the recession effects. It's a restraint on any speculative market and even the grain markets have speculative elements in them.

Senator SARBANES. Is it your view that inflation ought to be combatted by recession?

Mr. VOLCKER. No; I just made the point that we haven't got a palatable policy in this country if the only way we can achieve price stability is by having extended recessions. We've got to build in something more fundamental than that.

Senator SARBANES. I understand yesterday that you made the point in the House that a number of European countries had lower inflation and lower interest rates but larger swings in the money supply. Is that correct?

Mr. VOLCKER. Virtually all have larger swings in the money supply. I didn't add the point about interest rates and the other point you made.

Senator SARBANES. Let me quote the article and maybe you can misquote it. "Volcker reeled off a string of figures showing that other countries with low inflation and low interest rates have had bigger swings in the money supply."

Mr. VOLCKER. I think that was an editorial comment that happens to be correct for a good many countries, and I could reel off the figures again if you would like. They included countries that had lower inflation rates and lower interest rates and higher inflation rates and higher interest rates.

Senator SARBANES. Why should the Fed be pursuing a policy that focuses on the money supply as a significant indicator rather than the interest rates, which after all are the indicators that business activity has to work from? The small businessman doesn't work off of a money supply figure. He works off of an interest rate. If you put it out of his reach you're driving him out of business, and I'm hearing from people—not marginal people, you know—who have been driven out, well-established, longstanding business enterprises.

Mr. VOLCKER. I think you're right; the thing that affects the fellow out there, the small businessman, the farmer, the homebuilder, is interest rates. That's what he sees and that's what motivates him in an immediate sense. The problem is that it's become increasingly difficult through the years, with the inflationary process, to rely on your judgment about what the appropriate level of interest rates is. The alternative is to rely upon these quantitative indicators and, as I said earlier, I would not go all the way on any

single one of them. I think you have a variety of indicators that you have to assess in terms of what's influencing them and what is not. As you know, a very basic economic relationship that has been studied over literally centuries is the relationship between the supply of money, or the things we call money, and inflation.

Senator SARBANES. How much worse do you expect the recession to get?

RECESSION BOTTOMING OUT

Mr. VOLCKER. Our analysis is like that of many others, that we think we are in at least the beginnings of the bottoming out and the prospects are good for some recovery before midyear.

Senator SARBANES. Do you expect the unemployment figures to worsen?

Mr. VOLCKER. In the very short run that seems to be likely, certainly since the January figure was a little flukish, but the unemployment figure lags recovery in ordinary circumstances.

Senator SARBANES. How high do you expect the unemployment figure to go?

Mr. VOLCKER. I gave you some projections for the members of the FOMC in general. The range for the fourth quarter that was cited by FOMC members was 8.25 to 9.5 percent.

Senator SARBANES. What page?

Mr. VOLCKER. Page 25.

Senator SARBANES. Of course, that's the highest unemployment since World War II.

Mr. VOLCKER. 9.5 would be the highest rate, I believe, since World War II.

Senator SARBANES. That's not a very satisfactory economic performance.

Mr. VOLCKER. Clearly not.

Senator SARBANES. I come back to the point that to some extent the high interest rates have contributed to the downturn and to throwing people out of work. You have put us in a catch-22 situation. You express the concern over the deficit and yet the high interest rates contribute to the deficit by causing a slackening of economic activity, and every point on the unemployment rate is, what, $25 to $30 billion on the deficit?

Mr. VOLCKER. We are caught up in a vicious cycle that we have to get out of, but I have not expressed, I repeat, great concern about the deficit this year insofar as its cyclical component is concerned.

Senator SARBANES. The viciousness of that cycle is not being felt by you or by me directly. It's being felt by countless men and women out there who have lost their jobs, who are unable to find work, who have used up all their savings. They are selling off whatever capital assets they have—businessmen who are going bankrupt and small businesses that have got out. These people will never be able to come back.

Mr. VOLCKER. I could not agree with you more, and that's why it seems to me absolutely essential that we develop policies and programs that are going to get us out of this vicious cycle. This thing was not invented in July 1981. Economic performance has deterio-

rated literally, with some cyclical ups and downs, for 5 or 6 years. If we were to just project that trend 10 years into the future, we would have unemployment rates of a lot more than 9 percent. Let's make this the finale to that unsatisfactory performance and get some programs and policies in place that promise sustained recovery for all those people over a period of time.

Senator SARBANES. Well, we're not going to be able to do it as I perceive it with your interest rates.

Mr. VOLCKER. They are not my interest rates.

Senator SARBANES. No, they're not. I take that back. It's a concerted policy, as I understand it, and obviously flows out of the discussions you have had with the President, but you've got one foot on the accelerator and one foot on the brake.

Would you say that fiscal and monetary policy are working in a complementary fashion today?

Mr. VOLCKER. Not with the budgetary deficits that loom out there in the future.

Senator SARBANES. Well, thank you, Mr. Chairman.

The CHAIRMAN. Mr. Chairman, you have been very patient. I only want to make one remark and I'd like Senator Sarbanes to stay long enough to hear it. I don't disagree with anything anybody has said today about the difficulties of the economy or how critical it is. I think there's enough blame to go around for anyone. The only disagreement I would have with Senator Sarbanes, or what appeared to me to be at least some attempt to indicate this has all been caused since Ronald Reagan became President, and my purpose is not to start a partisan debate or say there aren't some problems during this year. I don't like the $100 billion deficit, but I would only say and reiterate what you just said, this has been building for a long time. Both Republicans and Democrats have served in this Congress. Lots of us voted different ways. I don't think it adds to a solution of the problem to attempt to indicate that its yours or Ronald Reagan's fault in 1 year. I seem to remember in November 1980, prior to the man being sworn in, the prime rate was 21.5 percent. It was high during all of 1980—18, 19 percent except for a brief blip, and I certainly don't intend or think it's useful to go back and suggest that was all Jimmy Carter's fault and yours during 1980. There may be some sort of the blame, but I really believe it's not useful to assess blame backward, forward, or anything else, but attempt to get together, as you have said and many others, and try to come up with a coherent, coordinated fiscal and monetary policy that will attempt to get us out of this cycle that has occurred during both Democratic and Republican administrations and Democratic and Republican Congresses.

So I just—Paul, I'm not trying to start anything.

Senator SARBANES. Well, you have started something, Mr. Chairman. Let me say I don't deny that we face tough economic problems and we need to address them. The only point I'm making is that the policies that are being pursued are compounding those problems rather than easing them.

The CHAIRMAN. Well, I'm not going to get started.

Senator SARBANES. I don't see anything the chairman has said here today that really differ with that. What we have had is an unemployment rate that was 7 percent in July that is now predicted

to go above 9 percent. That's $60 billion additional to your Federal deficit, simply by that two-point increase in the unemployment rate.

The CHAIRMAN. Senator, the statement you just made is quite different than what you have been making. You said compounded. I don't argue that one way or another. I don't think it's useful to take the chairman's time to argue how much compounding has gone on. I'm not satisfied with this budget, but the indication was somehow that this has all occurred in 1 year, and that is the point that I was trying to make. You're an economist. I'm not. And you, better than anybody else, should know things in an economy like this do not happen in a few weeks or months. They build over a period of years and any attempt to blame it on anybody—I think it would be terribly unfair if I, as a Republican, went back and tried to say we have inherited every bit of this; it's all somebody else's fault; it's all Jimmy Carter's fault. That's ridiculous. It isn't all Jimmy Carter's fault and it isn't all Ronald Reagan's fault at this point and I don't think trying to establish partisan blame is helpful in the solution of the problem and that's all I'm saying, that I don't think Paul Volcker and Ronald Reagan are conspiring to do this any more than Jimmy Carter and Paul Volcker were conspiring to do it, and this fiscal policy has been building for a long time before you and I even served in the Congress.

ESTABLISHING A TRUST FUND

The last question I wanted to ask the chairman was on this debt. It wasn't built by Jimmy Carter or Ronald Reagan. It had been building for a long, long time. I want to ask you a hypothetical question, not that I'm advocating this, but I've heard it discussed. Because of the drag—to address how much impact even if we balance the budget immediately, that drag on the economy of carrying and financing the trillion dollar debt, more than 13 percent of the budget, is interest on the national debt? And second, the proposal that's been talked about by some in establishing a trust fund such as the national highway trust fund and imposing a 5-percent gross receipts tax, not a value-added tax at all levels, excluding food and drugs and necessities of that kind. It would raise close to $200 billion a year for the sole purpose of reducing the debt—apart from attempting to reduce current additions to that debt, to reduce that national debt over a period of several years to reduce the interest cost and to reduce the drag on the private sector. Is that a feasible thing to even consider?

Mr. VOLCKER. Let me respond quite quickly. I think the carrying of the present debt, the carrying of a somewhat bigger debt in the context of the kinds of things you would like to happen, would present no great problem. In a disinflating world, we would certainly get interest rates down. Those interest payments would not loom historically large in the context of the postwar period, if we could curtail the debt and see interest rates come down. I don't have the exact figures in front of me, but I think carrying the present debt is not a major problem, all other things being equal. We would like to see it reduced, but we haven't done that for a long time and that doesn't, in itself, present a great problem.

These proposals that you occasionally see for revenue segregated to a trust fund to reduce the debt—and I don't know the particular proposal you may be referring to—often have an aspect of evading the problem. It doesn't do much good to run some revenues through a trust fund dedicated to reducing the debt when, on the other hand, you're running a bigger deficit and increasing the budget.

The only thing that really affects the debt in the end is the surplus or deficit in the budget as a whole.

The CHAIRMAN. I don't disagree with you and, again, I want you to understand that was not my proposal. I was just asking your opinion. I'm not advocating that, but certainly if I were, it would have to be a coordinating approach to balancing the budget to go beyond and reduce that drag, to have additional tax revenues much more rapidly than you could handle the individual budget to balance, and have some surplus, to actually have large reductions in the total debt as rapidly as possible to reduce that drag too. So they are talking about a double approach.

Mr. VOLCKER. Obviously, the problem strikes me as less urgent than dealing with the deficit. I think you're really posing the question of do you go beyond that?

The CHAIRMAN. Well, less urgent, but $115 billion—you've got a debt of $91 to $115 billion or so and if you start to eliminate some of that interest, that's $115 billion in interest.

Mr. VOLCKER. Professor Tobin, whose name was raised by Senator Sarbanes, has in the past, I think, often made a point very close to yours, that if we're worried about savings and private investment in the economy, a big source of savings would be a government surplus. That would be a better mix of policy—having a government surplus and freely available credit in the market would support the private investment side of the economy and ultimately the growth of the economy.

There's obviously a great deal to be said for that view. It sounds to me more like the challenge of the next decade than this one, as things stand at the moment, but I think it's useful to keep that point of view in mind. If you're worried about a shortage of savings in this economy, if you're worried about a shortage of business investment, productive investment, if you're worried about a shortage of housing, then running a government surplus and retiring the debt releases savings for other purposes and relieves some pressures on the budgetary situation itself.

The CHAIRMAN. I couldn't agree with you more. I used to be mayor of a city in a State that said, "Mayor, thou shalt balance thy budget or thou shalt go to jail," so we balanced the budget.

I appreciate very much your patience. You have been here more than 3 hours. You have been very kind to put up with all of these questions, and the committee will stand in adjournment.

[Whereupon, at 1:10 p.m., the hearing was adjourned.]

[Material received for the record follows:]

Statement by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

I appreciate the opportunity to meet with members of this distinguished committee today to discuss the direction of monetary policy and the prospects for the national economy. I have submitted for the record the official report from the Board in accordance with the Humphrey-Hawkins Act. I would now like to take a few minutes to underscore and amplify some of the points in that report, as well as to offer some more personal views on the problems -- and equally important, the opportunities -- that are before us.

As you know, the economy has been in recession for some months. The recession has some of the characteristics of earlier downturns. But it seems to me plainly wrong to think of the current state of the economy as simply reflecting "another" recession.

Rather, we are seeing the culmination of a much longer period of unsatisfactory economic performance extending well back into the 1970's -- performance marked by poor productivity, growing unemployment, much higher interest rates, and pressures on the real earnings of the average citizen and on the real profits of our businesses.

A number of factors have contributed to that deterioration in our performance, not all of them completely understood. But one pervasive element -- an element particularly relevant to monetary policy -- stands out: we found ourselves in the midst of the most prolonged inflation in our history, and that inflationary process had come to feed on itself. Incentives were distorted.

Too much of the energy of our citizens was directed toward seeking protection from future price increases and toward speculative activity, and too little toward production. Increasingly depressed and volatile capital markets reflected the uncertainties. Effective tax rates increased as inflation carried taxpayers into higher brackets. But, in a sluggish economy, those revenues did not keep up with our spending plans and programs.

Against that background, the notion that we might comfortably live with inflation -- or that we could accept inflation in the interest of strong growth -- was exposed as an illusion. I believe it is fair to say a clear national consensus emerged that turning back inflation had to be a top priority of economic policy -- that a stable dollar is a necessary part of the foundation of a strong economy.

Monetary policy has a key role to play in restoring that stability, and our policies are directed to that end. But recent developments have confirmed again that ending an inflation, once it has become deeply seated in expectations and behavior, is not a simple and painless process. The problems can be aggravated if too much of the burden rests on one instrument of policy. And the effort to restore stability will be more difficult to the extent policies feed skepticism and uncertainty about whether the effort will be sustained -- a skepticism rooted in past failures to "carry through." Monetary, fiscal, and other public policies are constantly scrutinized -- in financial markets and elsewhere -- to detect any signs of weakening in the sense of commitment to deal with inflation. To speed the transition to

lower interest rates and healthier capital markets, to reduce the costly elements of anticipated inflation built into wage and price contracts, to permit more confident planning for the future -- to, in fact, lay the base for sustained recovery -- credibility in dealing with inflation has to be earned by performance and persistence.

That, essentially, is what public policy -- and monetary policy in particular -- has been about for some time, and there are now signs of real progress on the inflation front. That progress is reflected to greater or lesser degree in all the widely used inflation indices. Consumer prices rose 8.9 percent last year, 3-1/2 percentage points less than the 1980 peak, and the inflation rate seemed to be trending lower still as the year ended. Finished goods producer prices have had an average increase at an annual rate of only about 4 percent for six months. Expectations cannot be so easily measured, but earlier fears that inflation might rapidly accelerate have plainly dissipated.

Those gains, to be sure, have elements that may not be lasting. Some prices are depressed by recession-weakened markets, and some by the pressures of high interest rates on inventories and speculative positions; exceptionally good crops last year have held food prices down, and surpluses have emerged in oil markets, following the enormous price increases of earlier years.

But we also see evidence of potentially more lasting changes in the trend of costs as management and labor in key industries come to grips with competitively damaging productivity and wage trends. I am aware that this process has just begun, and it has been centered largely in areas where competitive pressures are most intense. But as the emerging patterns spread, we will have succeeded in establishing one of the major elements for success in the fight against inflation and for reconciling, as we must, a return to greater price stability with growth, reduced unemployment, and higher real wages. Quite obviously, policies that encourage that process of cost moderation will have a large "pay off" in future economic performance.

I am acutely aware that progress on the inflation front has been accompanied by historically high levels of interest rates and heavy strains on financial markets. Those sectors of the economy particularly dependent on borrowing -- especially long-term borrowing -- have been hard hit.

The pattern of economic activity last year shows the picture clearly. Over the course of 1981, the overall level of production of goods and services -- real GNP -- posted a slight increase. But at the same time, home building dropped to the lowest level in decades. Sales of consumer durables -- car sales in particular -- fell markedly. And now capital investment by businesses also appears to be adversely affected, running contrary to longer-term needs.

It would be simplistic to cite high interest rates as the sole cause of the difficulties in these vulnerable sectors. Part of the problem arises from other, and longer-term, factors, themselves associated with the inflationary process. In housing, for example, we have had a decade of increases in prices of homes almost double the rate of inflation in the economy generally and well in excess of the rise in average family income. "Sticker shock" still seems to be the major deterrent to new car sales as the industry comes to grips with long developing competitive and regulatory problems and the enormous challenge of adapting to the higher price of gasoline.

In the best of circumstances, coping with deep-seated inflation would pose difficulties. At the same time, we have had to adjust to the huge increases in the price of energy, to meet the need for a stronger defense, and to deal with the drag on incentives and investment resulting from rising marginal tax rates. All of that implies massive economic adjustments, the threat of a growing fiscal imbalance, and a difficult transition period. The high level of unemployment generally, and particularly distressing conditions in some of our older industrial centers, are one symptom. Lasting progress toward price stability -- and other needed adjustments -- cannot be built on prolonged stagnation, rising unemployment, and slow growth. The relevant question is not whether current conditions are satisfactory or tolerable -- they obviously are not. It is whether our policies, and our policy mix, promise to achieve the

needed results over time.

Monetary Policy in 1981 and the Targets for 1982

It is against that background that I would like to review monetary policy last year and discuss our intentions for 1982.

As you know, the main responsibility for dealing with inflation has fallen on monetary policy. I would emphasize that the process of restoring stability will proceed more easily and effectively, with less strain on financial markets and on credit-sensitive sectors of the economy, to the extent the effort is complemented and supported by other policies. But, in the end, history and theory alike confirm that no effort to turn back inflation can be successful without appropriate restraint on the expansion of money and credit. I believe the record of the past few years amply reflects the needed monetary discipline.

The Humphrey-Hawkins Act specifically requires that we translate our broad objectives into quantitative monetary and credit targets. More broadly, those targets have become one means of communicating our intentions to the public in a comprehensible way. The judgments involved in setting appropriate targets are never simple, and they have been increasingly complicated by the rapid pace of innovation in financial markets. Those innovations sometimes blur the precise meaning of the various monetary and credit aggregates, complicate their measurement, or change the economic significance of a particular target. In the circumstances, elements of judgment

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are necessary in interpreting behavior of the aggregates, particularly when their movements diverge somewhat.

The events of 1981 surely reflect those facts, but they also seem to me to provide an unambiguous record of persistent monetary restraint. The targets we set for the year pointed toward a reduction in the growth of the monetary aggregates from the rates of expansion in 1980. In our 1981 report to the Congress, setting forth those targets, we also suggested that changing preferences of the public for different types of financial assets -- influenced by regulatory developments and new "products" offered by financial institutions -- might tend to push the broader aggregate M2 to the upper part of its specified range, and that judgments about the course of the narrow aggregates -- M1-A and B -- would require taking account of shifts into NOW accounts, particularly during the early part of the year when they were newly introduced nationwide. These expectations were borne out, but as the year progressed the divergences among some of the aggregates became even wider than expected.

Measured by comparing fourth quarter averages in 1980 and 1981, M1-B growth (adjusted for the estimated shift of funds into NOW accounts)* in 1981 was 2.3 percent, a little more than

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*The "adjustment" allowed for shifts of funds into NOW accounts and similar instruments included in M1-B from sources outside of M1-B. The shift-adjustment was estimated on the basis of various surveys of depository institutions and individuals, as well as by statistical techniques. M1-B without adjustment rose by 5 percent, also below its indicated range. While the adjustment was necessarily estimated, we believe the "adjusted" data are more appropriate for assessing the trend in the money supply, particularly during the early part of the year when shifts were large.

one percent below the lower end of the target range specified a year ago (see Table 1 attached). You will recall that I reported to you in July that an outcome near the lower end of the range would be desirable.

Measured in the same way, M2 slightly exceeded the upper end of its range after rather closely following the upper bound as the year progressed. The subsidiary target range for M3 was exceeded by a greater margin, reflecting in considerable part some changes in the composition of commercial bank financing patterns toward domestic sources that had not been anticipated, while bank credit fell within, but toward the upper part of, its range.

In judging trends over a period of time, annual averages may be more meaningful. As Table 2 illustrates, average annual M1-B (adjusted) growth has declined by an average of 1.1 percentage point since 1978, to a rate of 4.7 percent in 1981. On the same basis, M2 growth was steady in 1979 and 1980, but actually rose by more than 1 percentage point in 1981. Over those years, both aggregates have been affected by institutional change. Relaxation of interest rate ceilings applicable to time deposits of depository institutions and the enormous growth of money market funds (both included in M2) tended to raise the trend of M2 over the period as individuals had incentives to lodge a larger proportion of their assets in these instruments. Assets in money market mutual funds are not included in M1, but the enormous growth of those funds, providing virtually immediate

availability of funds and check-writing privileges, diverted some money away from checking accounts in depository institutions which are included in M1. Given the technical and institutional changes bearing on M1 and its relative volatility, its movements need to be assessed in the light of developments with respect to the other aggregates. Indeed, a number of analysts attach greater weight to M2.

Experience during 1981 also illustrates the variety of forces impinging on interest rates and credit market conditions. Over long periods of time, there should be a relationship between interest rates and inflationary expectations -- that is, both lenders and borrowers might reasonably anticipate a small positive return on loanable funds in "real" terms, after allowing for inflation. When economic conditions were relatively stable in the postwar period and inflation low, that relationship with respect to long-term interest rates was fairly steady. But history is replete with deviations for a time in either direction, and high levels of income taxation distort the comparison. Before taxes, "real" interest rates (measured on the base of actual inflation) were negative during part of the 1970's, but recently have been extraordinarily high. One factor, particularly in long-term markets, appears to be concern about whether public policy will, in fact, "carry through" the fight on inflation.

Even with inflation subsiding, the threat of prolonged large Federal deficits as the economy recovers points to a more imminent concern -- direct government competition for a

limited supply of savings and loanable funds. The clear implication is greater pressure on interest rates than otherwise, with those interest rates serving to "crowd out" other borrowers. The most vulnerable, of course, are home-buyers and others particularly dependent on credit. But the consequences for business investment generally are adverse as well.

Monetary policy, of course, influences interest rates, but the relationship has several dimensions. As monetary restraint reduces and eliminates the risk of inflation over time, it will work powerfully toward a more favorable climate for longer-term borrowing, and in the credit markets generally. In the short-run, should inflation, economic growth or other factors increase the need and desire to hold money, restraint on the supply of money will ordinarily be reflected in pressures on short-term rates. However, to accept inflationary increases in the money supply in an attempt to lower interest rates would ultimately be self-defeating; even in the short-run, market sensitivities might well give the opposite result.

Some of these inter-relationships were evident in 1981. Short-term interest rates fluctuated over a wide range, but generally trended down from peak levels in the spring or early summer, falling particularly sharply as the recessionary forces became apparent in the fall. That was a period when pressures on commercial bank reserve positions were easing, consistent

with our monetary and credit targets. However, longer-term interest rates continued to rise for months after the peak in short-term rates, influenced in substantial part by growing concern about prospective budgetary deficits.

As growth in the money supply rose more rapidly late last year, and a very sharp increase developed early in January, the reserve positions of banks came under some renewed pressure as Federal Reserve open market operations constrained the supply of reserves. At the same time, there were scattered signs recessionary forces might be waning. Short-term interest rates rose from early November lows, although they remain well below levels prevailing during much of 1981. Some long-term interest rates -- notably those on government securities -- returned close to earlier peaks, suggesting the impact of current and prospective Treasury financing.

This was the setting for the decision on the monetary and credit targets taken by the Federal Open Market Committee last week. The sharp increase in the money supply in January carried the level well above the fourth quarter 1981 average, the conventional base for the new target, and somewhat above the lower end of the range specified for 1981. A large increase in the money supply, accompanied by higher interest rates, is unusual during a period of declining production and economic activity. Moreover, the composition of the money supply increase in the past three months is heavily concentrated in a rather small component of M1 -- NOW accounts, which are held by individuals.

That increase in NOW accounts has been accompanied by a reversal of earlier sharp declines in savings accounts -- another highly liquid asset -- and by declines in small time deposits, which provide a less liquid outlet for personal funds. Taken together, the evidence suggests some short-term -- and potentially "self reversing" -- factors may be at work, inducing individuals to build up highly liquid balances at a time of economic and interest rate uncertainty.

Taking those circumstances and others into account, the Federal Open Market Committee decided to adopt the tentative targets discussed last July:

. for M1, 2-1/2 to 5-1/2 percent;

. for M2, 6 to 9 percent;

. for M3, 6-1/2 to 9-1/2 percent.

The associated range for bank credit is 6 to 9 percent.*

The M1 target is lower than the range specified a year ago for M1-B (3-1/2 to 6 percent shift-adjusted), but it is consistent with somewhat larger actual growth than experienced last year with the "adjusted" measure. The lower end of the range would now appear appropriate only if the pace of financial innovation again picks up -- for instance, a rapid spread of

---

*While all of the monetary ranges were set, as in previous years, on a fourth-quarter to fourth-quarter basis, the range for bank credit is measured from the average level in December 1981 and January 1982 to the fourth-quarter 1982 level. This adjustment in the base for bank credit is necessitated by the opening of International Banking Facilities on December 3, 1981, which led to a shifting of certain bank assets, formerly included in the domestic bank credit data, from U.S. offices to the IBFs.

arrangements for "sweeping" temporarily excess checking account balances into money market funds or other liquid assets not included in M1. Given the present level of M1 and the relatively slow growth last year, the FOMC at this time feels that an outcome in the upper half of the range would be acceptable, and that M1 could acceptably remain somewhat above the implied "growth track" during the period immediately ahead.

In that connection, I would point out that an outcome in the upper part of the range specified for 1982 would be roughly the equivalent of a rate of growth of 4 percent from the lower end of the range targeted in 1981, as illustrated on Chart II. Such a result would be entirely consistent with the objective I stated to your Committee in July.

The FOMC anticipates somewhat slower growth in M2 than a year ago, when the target was slightly exceeded. At present, an outcome in the upper half of the range appears more likely and desirable. Assets included in M2 account for a significant part of individual savings. Should total savings increase substantially more rapidly than now anticipated in response to tax incentives or other factors-- or if legal or regulatory changes, such as the wider availability of IRA accounts, result in a substantial volume of funds shifting into depository institutions from other sources -- growth might logically reach (or even slightly exceed) the upper limit.

Identifiable "structural" influences of that sort on M2, or other aggregates, must appropriately be taken into account in formulating policy steps and judging actual developments. For example, should developments in coming months provide solid evidence that the recent exceptional growth of M1 is indicative of some more fundamental and lasting change -- such as a desire by individuals to continue to hold more liquid "savings" in the form of NOW accounts -- the FOMC would, of course, reconsider that growth target at or before the regular mid-year review.

These technicalities should not confuse a simple message: consolidating and extending the heartening progress on inflation will require continuing restraint on monetary growth, and we intend to maintain the necessary degree of restraint. The growth ranges specified are, we believe, consistent with an economic recovery later this year, although we do not anticipate, by historical standards, a sharp "snap back." What is more important is that the recovery have a firm foundation -- that it be sustained over a long period. There will be more room for real growth -- and much better prospects for sustaining that growth over many years -- the greater the progress on inflation.

## The Course Ahead

In approaching the future, the lessons of the past bear repeating. We cannot buy or inflate our way out of recession -- not without ratcheting up both inflation and unemployment over

time. We cannot turn the effort to deal with inflation "on and off" -- not without adversely influencing the decisions of those in the marketplace who commit funds for investment, with consequences for the recovery and productivity we want.

What we can do is set the stage for a much more favorable outlook -- a future in which progress toward price stability, lower interest rates, greater productivity, slower growth in nominal wages but higher real wages, all benignly interact to support growth and reduce unemployment. That's a process we have not seen sustained in this country for many years.

Today, we are acutely aware of disturbed capital markets, high interest rates, economic slack, and a poor productivity record. But, when the economy begins to expand, productivity should rise; tax and other measures already in place or under way should help reinforce a better trend. Productivity growth, in turn, will permit prices to rise more slowly than wages -- more modest wage and salary increases in dollars will then be consistent with more growth in real earnings, encouraging further moderation in wage demands and sustaining the disinflationary process. As confidence returns to securities markets, prices of bonds and stocks should rise, and lower interest rates and more favorable capital market conditions will in turn support the continuing growth in investment and productivity. With appropriate budgetary and monetary discipline, the process could be sustained for years.

That is not an impossible vision. We saw something of it in the early 1960's. As recently as the mid-1970's, coming out of a deep recession, we seemed to be moving in the right direction -- and then lost our way. Some of the essential elements of a brighter future -- as well as some of the hazards on the way -- are reflected in the longer-term projections of both the Administration and the Congressional Budget Office now available to you.

From the standpoint of public policy, much of the groundwork has been laid. I have spoken of the key role for monetary policy, and of our record and intentions in that regard. The tax program enacted last year can, in the right context, have favorable effects on incentives and on investment. The excessive burden of regulation is being addressed.

But, of course, for the process to get fairly started we need to resolve some large outstanding questions as well -- questions that hang heavily over financial markets and prospects for interest rates, inflation, and early recovery.

I have referred on many occasions to the key importance of winding down the cost and wage pressures that tend to keep the inflationary momentum going. The process appears to be starting, and the faster it takes hold the better the outlook for growth and reduced unemployment. But, clearly, prospects for early and sustained expansion -- an expansion that can be broadly shared by industries now severely depressed -- is dependent on access to capital and credit on more favorable

terms. Pumping up the money supply cannot be the answer to that problem -- excessive money and the inflation it breeds are enemies of the real savings needed to finance investment.

What we can do is relieve the concerns the markets understandably have -- concerns reflected so strongly in the budgetary documents before you from both the Administration and your own Budget Office. Without action to cut spending -- or, if that fails, to raise new revenues -- we would face the prospect of deficits rising to unprecedented amounts, whether measured in dollars, in relation to the GNP, or as a proportion of our limited savings and the supply of loanable funds. We can debate among ourselves just what level of deficit is tolerable in coming years and what is not. We can be tempted to sit back and let a year pass as we discuss what programs should be cut or where revenues can be raised. But I think we all know that, without action, we would be on a collision course between our need for new plant, equipment and housing and our capacity to save -- and it would be more difficult to reconcile the requirements for a sound dollar with our desire to grow.

It could be argued we have a little time. A large deficit in the midst of recession should be manageable; it indeed provides some support for the economy in a time of stress. There are also large potential sources of demand in the private economy. The latest economic indicators are not so weak as they were. We can see we are making some progress against inflation, perhaps as fast as could reasonably have been anticipated. In all these circumstances, a degree of patience is needed -- and justified.

But delay is another matter. In my judgment, the more progress we can see in restraining costs, and the more resolute your budgetary action, the earlier we can be assured a prompt and strong recovery.

The course of action we have set in the Federal Reserve seems to me consistent with that sense of direction and urgency. But no single instrument of policy can, alone, do the job. We look forward to working with you and your colleagues in the weeks and months ahead to meet these challenges constructively.

* * * * * * *

Table I

Monetary Growth 1981

| | 1981 Ranges | 1981 Actual* |
|---|---|---|
| M1-B | 6 to 8-1/2 percent | 5.0 percent |
| M1-B (shift adjusted) | 3-1/2 to 6 percent | 2.3 percent |
| M2 | 6 to 9 percent | 9.4 percent |
| M3 | 6-1/2 to 9-1/2 percent | 11.3 percent |
| Bank Credit | 6 to 9 percent | 8.8 percent** |

*Fourth quarter to fourth quarter

**December level used for calculating this 1981 growth rate incorporates an adjustment to abstract from the shifting of assets from domestic banking offices to International Banking Facilities.

Table 2

Growth of Money and Bank Credit
(percentage changes)

| | M1-B* | M2 | M3 | Bank Credit |
|---|---|---|---|---|
| Fourth quarter to fourth quarter | | | | |
| 1978 | 8.3 | 8.3 | 11.3 | 13.3 |
| 1979 | 7.5 | 8.4 | 9.8 | 12.6 |
| 1980 | 6.6 | 9.1 | 9.9 | 8.0 |
| 1981 | 2.3 | 9.4 | 11.3 | 8.8** |
| Annual average to annual average | | | | |
| 1978 | 8.2 | 8.8 | 11.8 | 12.4 |
| 1979 | 7.7 | 8.5 | 10.3 | 13.5 |
| 1980 | 5.9 | 8.3 | 9.3 | 8.5 |
| 1981 | 4.7 | 9.8 | 11.6 | 9.4** |

*Growth rates for 1980 and 1981 adjusted for shifts to other checkable deposit accounts since the end of the preceding year.

**December level used for calculating these 1981 growth rates incorporates an adjustment to abstract from the shifting of assets from domestic banking offices to International Banking Facilities.

Table 3

Monetary Growth Targets 1982

| | |
|---|---|
| M1* | 2-1/2 to 5-1/2 percent |
| M2 | 6 to 9 percent |
| M3 | 6-1/2 to 9-1/2 percent |
| Bank Credit | 6 to 9 percent** |

*The objective for growth of narrowly defined money over 1981 is set in terms of M1. Based on a variety of evidence suggesting that the bulk of the shift to NOW accounts had occurred by late 1981, the Federal Reserve is publishing only a single M1 figure in 1982 with the same coverage as the former M1-B.

**The bank credit data after December 1981 are not comparable to earlier data because of the introduction of International Banking Facilities. Thus, the targets for 1982 are in terms of growth from an average of December 1981 and January 1982 to the fourth quarter average of 1982.

Chart 1

## Growth Ranges for 1981 and Actual

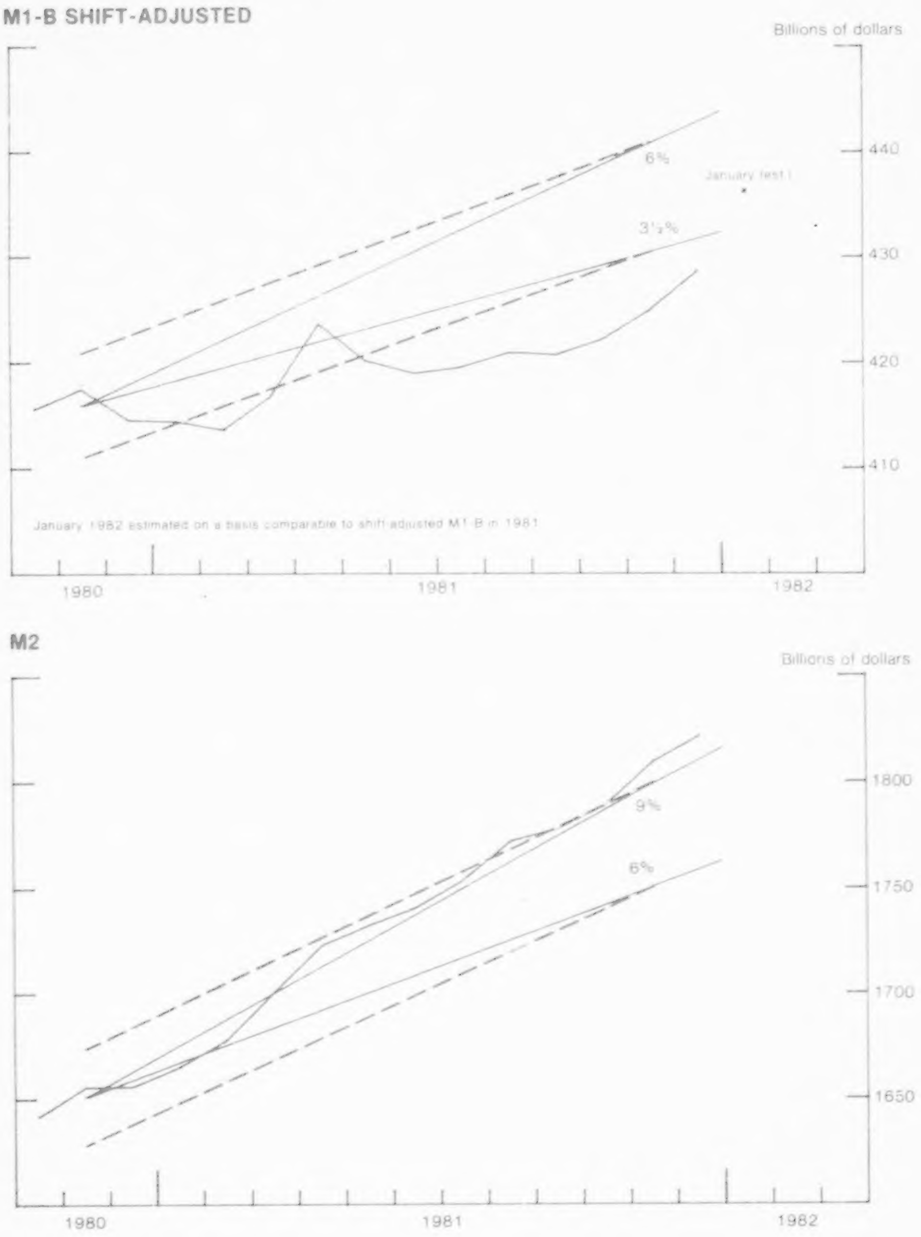
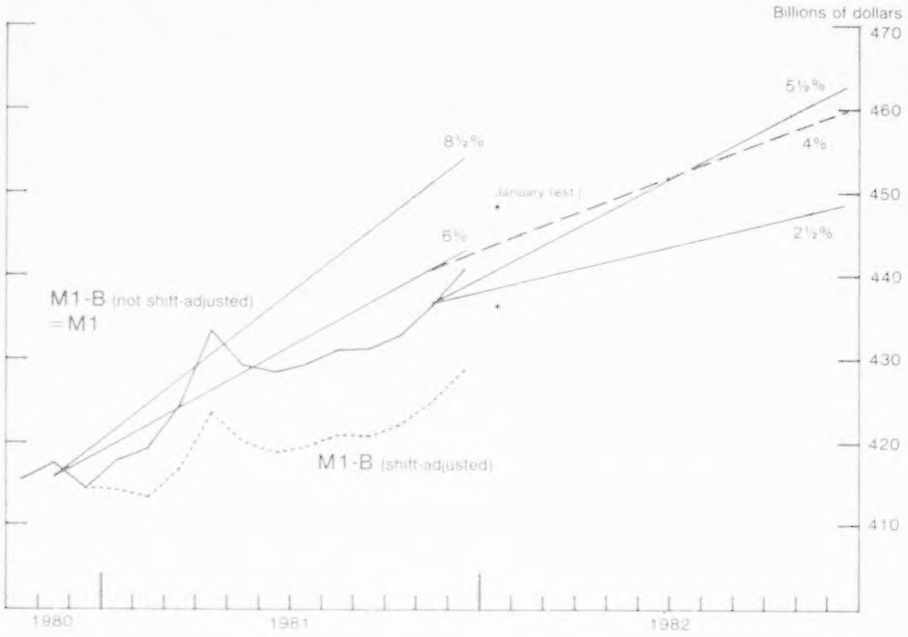


Chart 2

## Growth Ranges for and Behavior of M1, 1981 and 1982



# Letter of Transmittal

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM
Washington, D.C., February 10, 1982

THE PRESIDENT OF THE SENATE
THE SPEAKER OF THE HOUSE OF REPRESENTATIVES.

The Board of Governors is pleased to submit its Monetary Policy Report to the Congress pursuant to the Full Employment and Balanced Growth Act of 1978.

Sincerely,
Paul A. Volcker, Chairman

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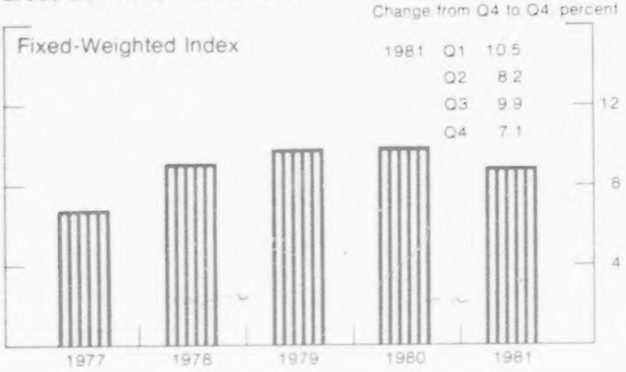
Section 1: Monetary Policy and the Performance of the Economy in 1981

The economy was growing rapidly as 1981 began, continuing the sharp cyclical rebound that started in mid-1980. Activity leveled out during the spring and summer, however, and it fell in the final quarter of the year. As a result, the rate of production of goods and services--real GNP--was only slightly higher at the end of 1981 than it had been a year earlier. With the weakening of output late in the year, the margin of unutilized plant capacity widened and the unemployment rate rose sharply to near postwar record levels.

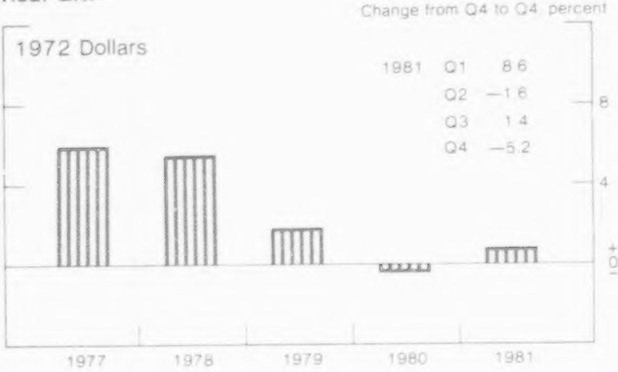
While economic activity was disappointing last year, there were emerging signs of progress in reducing inflationary pressures. The rate of price inflation slowed from the extremely rapid pace of the preceding two years, and as 1981 progressed there also were indications of an easing in the rate of wage increases, particularly in some key pattern-setting industries.

Confidence in the restoration of reasonable overall price stability is needed if economic growth is to be resumed on a sustained basis. The accelerating inflation of earlier years had been eroding the foundations of the nation's economy: capital formation had slowed; productivity was sagging; the functioning of basic market mechanisms was being impaired; and inequitable and capricious transfers of wealth were harming many of the weakest among us. The task of reversing the inflationary trend of earlier years was made more difficult because a decade of escalating prices and unsuccessful anti-inflation policies had led to firmly held expectations of continued high--if not accelerating--rates of inflation. Thus, it was recognized that reducing inflation would take time and that anti-inflation policies would

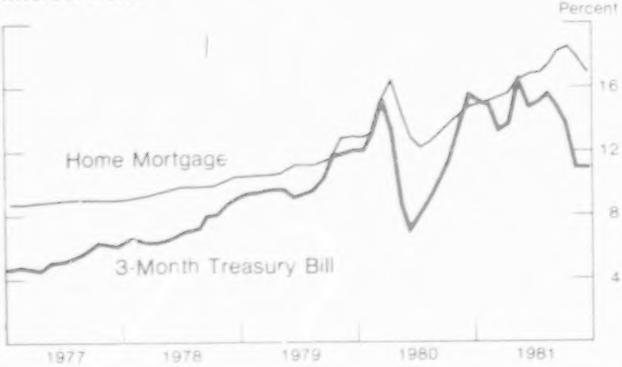
**Gross Business Product Prices**




**Real GNP**




**Interest Rates**



have to be applied with persistence if they were to be effective in altering expectations and slowing the rate of price increases.

While fiscal policy and decisions made in the private sector have much to do with the course of economic developments, economic theory and experience alike indicate that progress toward price stability cannot be obtained without adequate restraint on the growth of money and credit. Monetary policy was conducted in 1981 with this crucial fact in mind. The Federal Reserve set objectives for the growth of the monetary aggregates that it believed would help to damp inflation and would lead to movement over time toward trend rates of monetary expansion consistent with the growth of potential output at stable prices.

Short-term market rates of interest began 1981 at record levels, as rapid growth of economic activity in the second half of 1980 had pushed up the demand for money and credit faster than could be accommodated within the target ranges for growth of the monetary aggregates and bank reserves. Early in 1981 these demands began to subside, pressures on bank reserve positions were relieved, and money market rates declined for a time. A bulge in money demand early in the second quarter was steadily resisted by restraining the supply of reserves, and in the process short-term interest rates moved back to their earlier highs. By midsummer, short-term interest rates were declining, as demands for money and credit slackened while the Federal Reserve expanded nonborrowed reserves in an effort to maintain adequate monetary growth. Those interest rate declines accelerated in October and November as the recession took hold.

On balance, short-term interest rates--although volatile--moved down considerably over the course of 1981. In contrast, long-term rates

rose substantially over the period, despite declines in the last quarter of the year. The pressure on long-term rates appeared to reflect a combination of factors. Anticipations that continued large federal budget deficits would clash with private credit demands particularly as the economy expanded, putting strong pressures on credit markets, were a continuing strong investor concern. Despite reductions in the growth of many federal spending programs, federal borrowing in calendar year 1981 siphoned off roughly a quarter of the total funds available to domestic nonfinancial borrowers. In the background were continuing doubts and skepticism that anti-inflation programs would be carried through. Moreover, the volatility of the markets may have inhibited aggressive buying of longer-term securities.

The tensions in credit markets in 1981 had their greatest impact on business and household capital formation. Housing construction fell to its lowest level in the postwar period; only 1.1 million new housing units were started in 1981. The weakness in real estate markets last year reflected a number of influences. Of paramount importance, in the short run, was the cost of mortgage funds. The average rate on mortgages closed for new homes was 15.3 percent in the fourth quarter of 1981, up from 12.6 percent a year earlier. But it was not higher mortgage rates alone that cut into housing demand: high prices also adversely affected the ability of those seeking new homes to afford the monthly payments. Although house prices changed little in 1981, over the preceding 5 years prices of new and existing homes had risen half again as fast as the overall rate of inflation. As a result, the share of average family disposable income needed to service the monthly payment on a typical new mortgage rose from 21 percent in 1976 to nearly 40 percent last year.

Slow income growth and rising unemployment, along with the increased cost of credit, combined to damp consumer spending in 1981--particularly for more discretionary, large ticket items such as autos, furniture, and appliances. Since the mid-1970s, household real after-tax income has only been rising at a 1/2 percent annual rate, compared with a long-run trend of 2 percent. At the same time, the prices of essential items such as food, gasoline, heating fuel, utilities, and medical services--as a group--have been rising faster than the overall inflation rate, and the share of disposable income devoted to these items has been increasing. The resulting squeeze on family budgets led many households to overextend themselves during the last half of the 1970s, taking on more and more debt to finance their purchases.

With household balance sheets debt-laden and credit costs rising, a retrenchment in consumer borrowing began in 1980, and continued through 1981. As the year progressed, it appeared that household balance sheets were improving. Consumer debt burdens (the ratio of monthly debt repayment obligations to income) declined to their lowest level in more than five years. Moreover, partly in response to the higher after-tax income following the tax cut on October 1, the saving rate rose from about 5 percent in the first three quarters of 1981 to 6 percent in the fourth quarter.

In real terms, personal consumption expenditures rose 1-1/4 percent over the four quarters of 1981. The gain was concentrated in the early months of the year as real consumer spending fell, on balance, over the final three quarters of 1981. Purchases of new automobiles were hardest hit. Sales of domestically produced cars totaled 6.2 million units in 1981, the poorest performance in 20 years. The depressed conditions in the auto sector were related,

in part, to the typical cyclical volatility in the demand for motor vehicles and to credit market conditions, which affected the cost of financing new car and truck purchases. However, the current problems in the industry appear to be related mainly to longer-term trends in automotive demand. These include: the rapid increase in the price of new cars, high gasoline and other operating costs, sluggish real income growth, intense foreign competition, and government regulations that have necessitated large investments to comply with emission control standards and to improve fuel efficiency. As 1981 was ending, it appeared that the auto industry was taking aggressive actions to reduce costs and to improve the competitiveness of its products.

Business firms, like households, restrained their spending on investment goods in 1981. Demand was damped by a substantial degree of excess capacity and by the rising trend in corporate bond rates throughout much of the year, which boosted the real cost of capital. In real terms, expenditures for new plant and equipment rose only 1-1/2 percent over the four quarters of 1981. Although spending for new structures increased during the year, real equipment outlays fell for the second year in a row; the biggest declines were for electrical machinery and transportation equipment, while spending for most other capital goods remained weak.

In contrast to fixed investment outlays, sizable unintended inventory accumulation boosted business financing requirements. As the year went on, unexpectedly weak demand led to a build-up of excess stocks in several industries. The most pronounced problem was in autos, but other manufacturers and retailers also found their inventory levels uncomfortably high relative to sales. On balance, total nominal business capital spending--fixed investment and inventories--rose about 20 percent above the 1980 average.

Early in 1981, strong economic growth helped boost corporate internal funds, greatly reducing corporate needs for external financing. But as the economy slowed, corporate profits turned sluggish and businesses were forced to rely more heavily on credit markets to satisfy their rising capital needs. The bulk of business borrowing last year was in short-term markets, as most firms felt it best to defer making long-run commitments in the current financial environment. With the accumulation of additional short-term debt, however, corporate balance sheet positions deteriorated further, and the ratio of short-term to total debt of the nonfinancial corporate sector rose to a record high.

Real purchases of goods and services at all levels of government rose only moderately during 1981 as a sharp increase in purchases by the federal government was partly offset by curtailed spending at the state and local level. The rise in federal spending on goods and services reflected another large increase in defense purchases, while federal payroll reductions helped to contain increases in nondefense outlays. At the state and local level, real purchases fell 2 percent owing to a combination of the withdrawal of federal support for many activities, the continued impact of tax limitation measures, and the effects of a sluggish economy on tax revenues.

The weighted-average value of the dollar against major foreign currencies rose by nearly one-fourth during the period from January to August. The dollar eased somewhat in the last part of 1981, but at the end of the year still remained well above its year-earlier level. The improvement in the inflation outlook in the United States was a factor in the appreciation of the dollar. Moreover, at various times during the year changes in

the differential between interest rates on dollar assets and rates of return on foreign currency assets also had a noticeable impact on exchange rates.

Real exports of goods and services increased in the first quarter of 1981, in part because of strong GNP growth in one of our major trading partners, Canada. But for the next three quarters, real exports declined in response to a slowing of economic growth abroad and the effect of the appreciation of the dollar in 1980 and 1981. The volume of imports, other than oil, rose fairly steadily throughout the year. The current account, reflecting this weakened trade performance, shifted from a surplus in the first quarter to a deficit by the fourth quarter.

Employment grew at a moderate rate during the first three quarters of 1981 and the unemployment rate edged down. Job increases were strongest in the service and trade sectors. As economic activity began to contract in the autumn, the demand for labor fell sharply and the unemployment rate climbed to 8.8 percent in December--only fractionally below its postwar high. Layoffs in the durable goods and construction industries accounted for much of the drop in employment. As a result, the unemployment rate of adult men--who tend to be more heavily employed in these industries--jumped to a postwar record of 7.9 percent in December of 1981.

Labor productivity (output per hour worked) showed considerable fluctuation during 1981, reflecting the course of economic activity. Productivity rose at a 1-1/4 percent annual rate in the first three quarters of 1981. However, as often happens at the beginning of a cyclical downturn, output fell more than employment in the fourth quarter and productivity declined, offsetting the gains earlier in the year. Averaging across short-run cyclical

movements, productivity has shown little improvement in recent years, and thus has provided virtually no offset to the impact of rapidly rising compensation on unit labor costs.

Compensation and wage increases did decelerate during 1981--with continuing progress observed throughout the year. But the slowing was moderate, reflecting the basic inertia of the wage determination process, where many union contracts last three years or more and nonunion wage agreements usually are set annually. By the second half of 1981, however, some changes in those traditional wage-setting practices were under way in several important industries: management and workers alike began to reconsider planned wage adjustments, some expiring contracts were renegotiated well in advance of termination dates, and labor agreements at a number of firms were modified in an effort to ease cost pressures and to enable them to compete more effectively. These adjustments, coupled with the progress seen in reducing inflation during 1981, suggest that the nation's anti-inflation policies have set the stage for a sustained unwinding of wage and price increases.

The trend in inflation improved noticeably during 1981, and by year-end virtually all aggregate price indexes were advancing well below double-digit rates for the first time since 1978. The consumer price index rose 8.9 percent over the course of 1981, down from the nearly 13 percent average rate in 1979 and 1980. Important factors in the slowing of inflation were exceptionally favorable agricultural supplies and declines, after the first quarter, in world oil prices. Inflation in areas other than food and energy--particularly consumer commodities and capital equipment--also began to abate, although price pressures persisted in the consumer service sector, notably for medical care. As the year progressed, surveys of consumer expectations suggested that the inflationary psychology, which had increasingly permeated many aspects of economic behavior in earlier years, appeared to be subsiding.

Section 2: The Growth of Money and Credit in 1981

The Board of Governors in its report to Congress last February indicated that the System intended to maintain restraint on the expansion of money and credit in 1981. The specific ranges chosen by the Federal Open Market Committee (FOMC) for the various monetary aggregates anticipated a deceleration in monetary growth that would encourage further improvement in price performance. Measured from the fourth quarter of 1980 to the fourth quarter of 1981, and abstracting from the effects on deposit structure of the authorization of NOW accounts nationwide, the ranges adopted were as follows: for M1-A, 3 to 5-1/2 percent; for M1-B, 3-1/2 to 6 percent; for M2, 6 to 9 percent; and for M3, 6-1/2 to 9-1/2 percent. The associated range for commercial bank credit was 6 to 9 percent.

In formulating its objectives for 1981, the FOMC knew that the growth rates of the narrow aggregates would be affected markedly by shifts into NOW accounts which for the first time became available on a nationwide basis in January. Transfers into NOW accounts, which are included in M1-B, from savings deposits and other asset holdings not included in M1 were expected to be particularly large in the early months of the year. Thus, in order to avoid confusion about the intent of policy and to facilitate comparisons with previous years, the objectives announced for M1-B abstracted from such shifts.[1] Even after accounting for such shifts, however, the FOMC anticipated that the growth rates of the various aggregates were likely to diverge more than usual, reflecting the rapid pace of institutional change in financial markets. The FOMC indicated that if M1-B growth (adjusted for shifts into new NOW accounts and other

1. The shift adjustments were estimated on the basis of survey evidence and were published regularly over the past year.

checkable deposits) was about in the middle of its annual range, the growth of M2 was likely to be in the upper part of its range, given the popularity of the nontransactions components of M2 that pay market-related interest rates. It also was noted that the relationship of M3 and bank credit to their respective ranges would be influenced importantly by the pattern of credit flows that would emerge, and particularly by whether financial conditions would be conducive for corporations to refinance short-term borrowing in the bond and equity markets.

It soon became apparent as 1981 unfolded that the behavior of the aggregates was turning out to be even more divergent than had been anticipated. Growth rates of the shift-adjusted narrow aggregates were low in the opening months of the year, a development that was welcome following rapid growth in the latter part of 1980. A strong surge in April was offset by weakness over the remainder of the second quarter. On the whole, average growth in adjusted M1-B over the first half of 1981 was well below that which would have been expected on the basis of historical relationships among money, GNP, and interest rates. On the other hand, despite the weakness in M1-B, the broader aggregates expanded quite rapidly in early 1981. M2 growth over the first half was near the upper end of its annual range, while the expansion of M3 placed this aggregate above the upper bound of its range at midyear.

After reassessing its objectives for 1981 at midyear, the FOMC elected to leave unchanged the previously established ranges for the aggregates over the remainder of the year. However, in light of the reduced growth in M1-type balances over the first half of the year, indications that this weakness might reflect a lasting change in cash management practices of

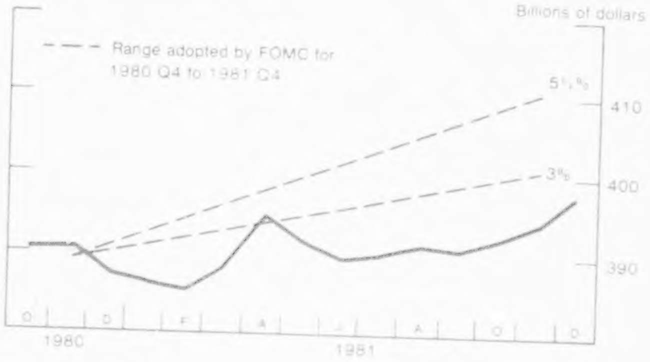
individuals and businesses related to the growth of alternative means of holding highly liquid funds, and given the relatively strong growth of the broader aggregates, the FOMC anticipated that growth of the narrow aggregates might likely and desirably end the year near the lower bounds of their annual ranges. Even so, given the sluggishness early in the year, this decision implied that growth of M1-A and M1-B would accelerate over the balance of the year. At the same time, the FOMC indicated that M2 and M3 might well end the year around the upper ends of their ranges. This expectation also reflected in part the possibility that regulatory and legislative actions as well as the popularity of money market mutual funds might intensify the public's preference to hold the type of assets encompassed in the broader aggregates.

Although growth of narrow money in the second half of the year was on average about the same as in the first half, M1-B strengthened appreciably in the final two months of the year. This acceleration appeared to reflect in part a lagged response to large short-term interest rate declines in the summer and fall and in part a shift in preferences for very liquid assets in an environment of heightened economic and financial uncertainty. Similarly, M2 growth in the second half was about in line with expansion in the first half, although growth in this measure also picked up at the end of the year. The expansion in M3, on the other hand, decelerated from the rapid pace of the first half, as sales of large CDs slowed in concert with a slackening in bank credit growth and stronger growth in core deposits.

Measuring growth for the year from the fourth quarter of 1980 to the fourth quarter of 1981, M1-B growth adjusted for shifts into NOW accounts was about 2-1/4 percent--1-1/4 percentage points below the lower end of its

## Growth Ranges and Actual Monetary Growth

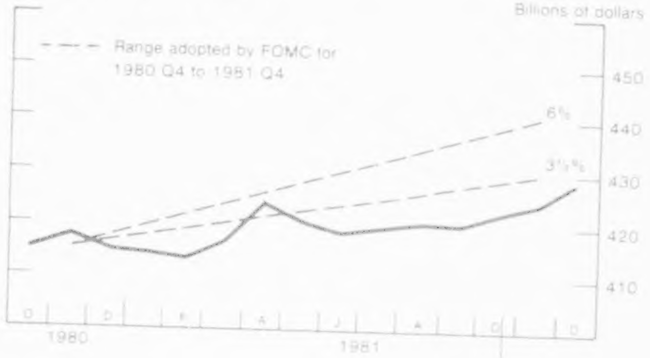
### M1-A Shift Adjusted *




Annual Rate of Growth

1980 Q4 to 1981 Q4
1.3 Percent

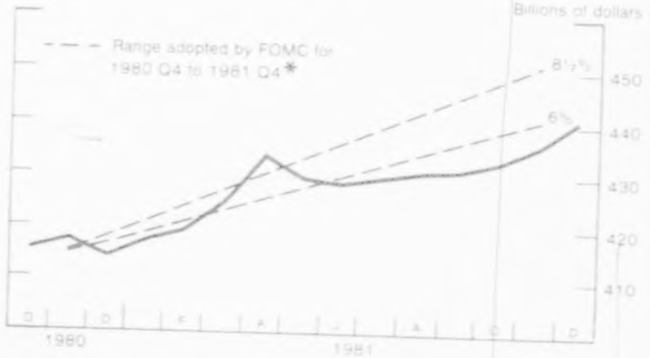
### M1-B Shift Adjusted *




Annual Rate of Growth

1980 Q4 to 1981 Q4
2.3 Percent

### M1-B



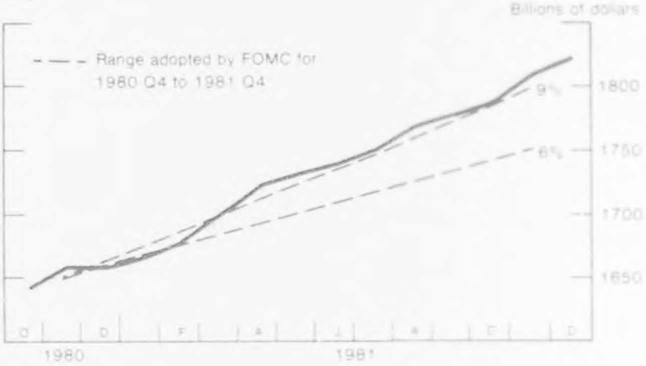

Annual Rate of Growth

1980 Q4 to 1981 Q4
5.0 Percent

* Adjusted for impact of nationwide NOW accounts.

## Growth Ranges and Actual Monetary and Bank Credit Growth

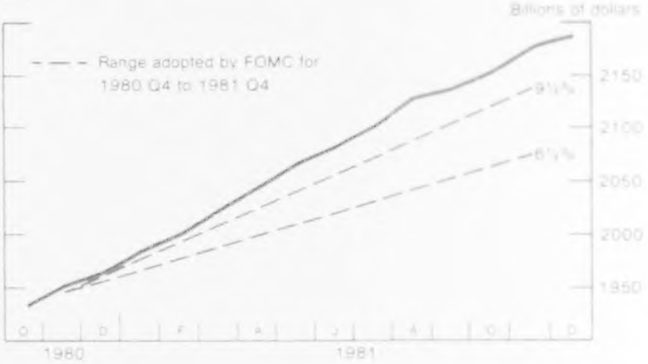
### M2




Annual Rate of Growth

1980 Q4 to 1981 Q4
9.4 Percent

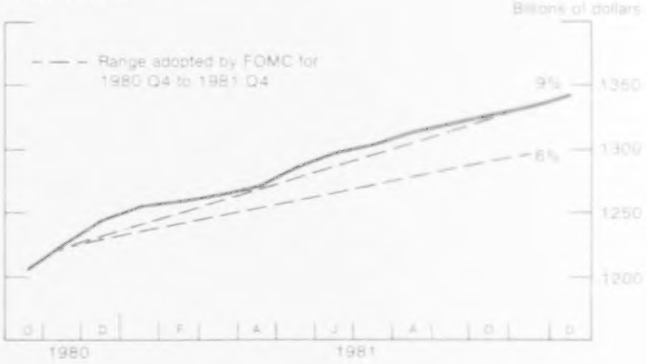
### M3




Annual Rate of Growth

1980 Q4 to 1981 Q4
11.4 Percent

### Bank Credit *




Annual Rate of Growth

1980 Q4 to 1981 Q4
8.8 Percent

* Data prior to February are adjusted for discontinuity in series. December figure is adjusted for shift of assets into International Banking Facilities.

targeted range.[1] Growth rates, of course, are affected by the particular pattern of variation that develops over the course of the year. Measuring expansion from December to December, "adjusted" M1-B growth in 1981 was at a 3-1/2 percent rate. On a yearly average basis, which reflects movements through the year as a whole relative to the level of the previous year, the increase was at a 4-3/4 percent rate. At the same time, measured from the fourth quarter of 1980 to the fourth quarter of 1981, growth of M2 was 9.4 percent, 0.4 percentage point above the upper limit of its range. Also, growth of M3 exceeded the upper end of its range by 1.9 percentage points, while bank credit growth was just inside the upper end of its annual range.

The table on page 14 puts the performance of the aggregates during 1981 into a somewhat longer-term perspective, showing two measures of annual growth. No matter which of the measures of annual growth is used, a marked deceleration in M1-B is apparent since 1978. The table also clearly illustrates that growth rates for the broader aggregates have been maintained around a higher level, and larger divergences have developed from M1-B growth. In considerable part, these differences can be explained by structural changes in financial markets.

As noted earlier, it was already obvious last February when the FOMC was meeting to set its objectives for 1981 that shifts into NOW accounts following their nationwide authorization at the beginning of 1981 would alter the behavior of the narrow aggregates. Data for early January had pointed to a very large movement of funds at the beginning of the year. However,

1. Unadjusted for shifts into NOW accounts, M1-B increased 5.0 percent from the fourth quarter of 1980 to the fourth quarter of 1981.

Growth of Money and Bank Credit
(percentage changes)

| | M1-B[1] | M-2 | M-3 | Bank Credit[2] |
|---|---|---|---|---|
| Fourth quarter to fourth quarter | | | | |
| 1978 | 8.3 | 8.3 | 11.3 | 13.3 |
| 1979 | 7.5 | 8.4 | 9.8 | 12.6 |
| 1980 | 6.6 | 9.1 | 9.9 | 8.0 |
| 1981 | 2.3 | 9.4 | 11.4 | 8.8 |
| Annual average to annual average | | | | |
| 1978 | 8.2 | 8.8 | 11.8 | 12.4 |
| 1979 | 7.7 | 8.5 | 10.3 | 13.5 |
| 1980 | 5.9 | 8.3 | 9.3 | 8.5 |
| 1981 | 4.7 | 9.7 | 11.5 | 9.4 |

1. Growth rates for 1980 and 1981 adjusted for shifts to other checkable deposit accounts since the end of the preceding year.
2. December level used for calculating these 1981 growth rates incorporates an adjustment to abstract from the shifting of assets from domestic banking offices to International Banking Facilities.

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the pattern and magnitude of subsequent movements could not be predicted with any certainty. As events unfolded, the shifts into NOW accounts were more concentrated in the early part of 1981 than was anticipated by the working assumptions of the Board's staff. Through June, the adjustments made to the aggregates to correct for such shifts had the effect of raising M1-A by $28 billion and lowering M1-B by $9-1/2 billion. Over the second half of 1981, further adjustments for shifts into NOW accounts raised M1-A by only another $6 billion and lowered M1-B by about $2-1/2 billion more. While these adjustments are imprecise and based on evidence from a variety of sources, data on the number of NOW accounts coupled with other available information confirm that the shifting of funds from demand deposits to new interest-bearing checking accounts tapered off considerably by the fall. A surge in NOW account balances near the end of the year and early in 1982 appeared to reflect primarily the precautionary savings behavior noted above rather than shifting of funds into new accounts.

As was indicated above, the growth of the narrow aggregates adjusted for shifts into NOW accounts was low in 1981 compared with the other aggregates and also relative to past relationships with income and interest rates. Continued high interest rates provided a substantial incentive for businesses to intensify efforts to pare narrow money balances and to make increasingly widespread use of sophisticated cash management techniques. At the same time, explosive growth of money market mutual funds (MMMFs), many of which offer check-writing or other third party payment services comparable to conventional checking accounts, appeared to induce some households to minimize checking account balances. Also, the broader availability of NOW accounts

may have stimulated households to reconsider in a more general way their habits of cash management.

Likewise, the strong growth of M2 over the past few years reflected changing financial practices. Money market funds and instruments offered by depository institutions that pay market-related interest rates have been accounting for an increasing proportion of M2, as such assets have become much more competitive with open market instruments. Indeed, the attractiveness of small time deposits was enhanced last year by the liberalization of the interest rate ceilings on small savers certificates and to a limited extent by the introduction of all savers certificates. Even so, three-fourths of the increase in the nontransactions components of M2 was accounted for by MMMFs which grew 140 percent last year.

The distortions in the aggregates resulting from the expansion in MMMFs are difficult to quantify. Surveys of household behavior and data on account turnover suggest that most shareholders of money funds have made little or no use of their accounts for transactions purposes. Thus, the direct substitution effect of MMMFs on the growth of M1 has appeared small, perhaps on the order of 1 percentage point on the rate of growth for the year. However, indirect effects may have been larger as the potential availability of such a highly liquid asset may facilitate holding less funds in demand and NOW accounts.

The direct effect of MMMFs on M2 appears more substantial in dollar terms. Presumably, the great bulk of the $20 billion inflow in 1981 to MMMFs catering only to institutional investors was funds that otherwise would have been invested in assets not included in M2. In addition, it seems likely

that a small portion of the $90 billion growth in other types of MMMFs also reflected diversions from assets not in M2.

In light of the sizable distortions created by the growth of institution-only MMMFs, M2 has been revised to exclude such funds but they will continue to be a component of M3. In addition, M2 has been revised to include retail RPs. Retail RPs, which previously had been a component only of M3, were promoted on a substantial scale in 1981, likely attracting funds mainly from household small time deposits and MMMF holdings and thus resulting in a downward bias on M2 growth. The net effect on M2 growth of reclassifying institution-only MMMFs and retail RPs, along with other minor revisions, was small.

M3 increased more rapidly than M2 last year largely because of the substantial expansion in large CDs, particularly over the first half of the year. With growth of core deposits weak on balance over the year, depository institutions increased their managed liabilities to support expansion in loans and investments.

Bank credit growth accelerated somewhat in 1981 but stayed just within the upper end of its annual target range. The pick-up in bank credit growth was concentrated in business loans. Growth in this category was bolstered by the high level of corporate bond rates through most of the year, which tended to focus business credit demands on short-term borrowing such as bank loans and commercial paper. Although merger activity contributed significantly to the growth of loan commitments over the year, actual takedowns for this purpose influenced loan growth only slightly. Real estate loans at banks in 1981 grew at about the same moderate pace as in the prior year, while

consumer lending strengthened a little from 1980. Security holdings at banks grew somewhat more slowly than loans in 1981.

The bank credit data in December were affected by the shifting of assets to accounts in the newly authorized International Banking Facilities (IBFs). It is estimated that about $22 billion of loans to foreign customers were shifted from U.S. offices to IBFs in December. The data presented in this report are adjusted for this shift. Without this adjustment, the increase in bank credit from the fourth quarter of 1980 to the fourth quarter of 1981 was 8-1/4 percent, one-half percentage point less than shown by the adjusted data.

Broader measures of credit flows reflected the slowing pace of production and income in 1981 and the effects of high interest rates. Households and businesses continued to increase their borrowing over the first three quarters, but their use of credit contracted in the fourth quarter in response to the weakening of the economy. In view of the high level of long-term interest rates during most of 1981, virtually all of the increase in funds raised was in short-term debt instruments. Overall, net funds raised by nonfinancial sectors rose 7 percent in 1981 and continued to fall relative to GNP for the third consecutive year.

Section 3: The Federal Reserve's Objectives for the Growth of Money and Credit

The Federal Reserve remains committed to restraint on the growth of money and credit in order to exert continuing downward pressure on the rate of inflation. Such a policy is essential if the groundwork is to be laid for sustained economic expansion.

There was a distinct slowing of inflation during 1981, and the prospects for further progress are good. Failure to persist in the effort to maintain the improvement would have long-lasting and damaging consequences. Once again, underlying expectations would deteriorate, with potentially adverse effects on financial markets, particularly long-term rates. The result would be to embed inflation even more deeply into the nation's economic system--with the attendant debilitating consequences for the performance of the economy. A failure to continue on the current path would mean that the next effort would be associated with still greater hardship.

Progress toward price stability can be achieved most effectively and with the least amount of economic disruption by the concerted application of monetary, fiscal, regulatory and other economic policies. But it is quite clear that inflation cannot persist over an extended period unless financed by excessive growth of money. Thus, a policy of restraint on the growth of the monetary aggregates is a key element in an anti-inflation strategy.

Targets for the monetary aggregates have been set with the aim of slowing the expansion of money over time to rates consistent with the needs of an economy growing in line with its productive potential at reasonably stable prices. The speed with which the trend of monetary growth can be lowered without unduly disturbing effects on short-run economic performance depends, in part, on the credibility of anti-inflation policies and their

effects on price expectations as well as on other forces influencing interest rates and credit market demands, including importantly the fiscal position of the federal government. More technically, financial innovation or other factors affecting the demand for specific forms of money need to be monitored.

In its deliberations concerning the target ranges for 1982, the Committee recognized that the recent rapid increase in M1 placed the measure in January well above the average level during the fourth quarter of 1981, the conventional base for the new target. Experience has shown that, from time to time, M1 growth can fluctuate rather sharply over short periods, and these movements may be at least partially reversed fairly quickly. The available analysis suggested that the recent increase reflected in part some temporary factors of that kind, rather than signalling a basic change in the amount of money needed to finance nominal GNP growth.

In the light of all these considerations, the FOMC reaffirmed the following ranges of monetary expansion--tentatively set out in mid-1981--for the year ending in the fourth quarter of 1982: for M1, 2-1/2 to 5-1/2 percent; for M2, 6 to 9 percent, and for M3, 6-1/2 to 9-1/2 percent.[1] The FOMC also adopted a corresponding range of 6 to 9 percent for commercial bank credit. These ranges are the same as those agreed to in July and reaffirm the

1. The objective for growth of narrowly defined money over 1982 is set in terms of M1 only. Last February, when the FOMC set its targets for narrow money, it was recognized that regulatory changes allowing for the establishment of nationwide NOW accounts would distort the observed behavior of M1-A and M1-B. Accordingly, the targets were set on a basis that abstracted from the shifting of funds into interest-bearing checkable deposits. Based on a variety of evidence suggesting that the bulk of the shift to NOW accounts had occurred by late 1981, the Federal Reserve reaffirmed in December its previously announced intention that starting in January 1982 shift adjustments would no longer be published and only a single M1 figure would be released with the same coverage as M1-B.

Federal Reserve's commitment to reduce inflationary forces. As has been typical in the past, these changes are measured from actual fourth quarter levels from the previous year.[1]

During 1981, M1-B (shift-adjusted) rose relatively slowly in relation to nominal GNP.[2] On the assumption that the relationship between growth of M1 and the rise of nominal GNP is likely to be more normal in 1982, and given the relatively low base for the M1-B range, the Committee contemplated that growth in M1 this year may well be in the upper part of its range. At the same time, the FOMC elected to retain the 2-1/2 percent lower bound for M1 growth tentatively set last July in recognition of the possibility that financial innovations--especially techniques for economizing on the use of checking account balances included in M1--could accelerate, with restraining effects on M1 growth.

The actual and potential effects on M1 of ongoing changes in financial technology and the greater availability of a wide variety of money-like instruments and near-monies strongly suggest the need for also giving careful attention to developments with respect to broader money measures in the implementation of monetary policy. The range for M2 growth is the same as in 1981 when actual growth slightly exceeded the upper bound of the range. The Committee contemplated that M2 growth in 1982 would be somewhat below the 1981

1. Because of the introduction of International Banking Facilities, the bank credit data after December 1981 are not comparable to earlier data. Thus, the targets for 1982 are in terms of growth from an average of December 1981 and January 1982 to the average level in the fourth quarter of 1982.
2. M1-B velocity, before shift adjustment, rose at a rate closer to historical experience. However, the shift of funds from savings accounts or other sources of funds not included in measures of the narrow money supply temporarily depressed that velocity figure, particularly early in the year.

pace, although probably in the upper part of the range. However, should personal saving, responding to recent changes in tax law or other influences, grow substantially more rapidly in relation to income than now anticipated, or should depository institutions attract an exceptionally large inflow to IRA accounts from sources outside measured M2, growth of M2 might appropriately reach--or even slightly exceed--the upper end of the range. The ability of depository institutions to compete for the public's savings will, of course, also be affected in part by deregulatory decisions that may be made by the Depository Institutions Deregulation Committee.

The 1982 ranges for M3 and bank credit were left unchanged from those for 1981. These aggregates again will be influenced importantly by the degree to which credit demands tend to be focused on short-term borrowing and are funded at home or abroad.

Section 4: The Outlook for the Economy in 1982

Economic activity still appears to be contracting; industrial production and employment certainly declined further in January, with the extent of the fall worsened by exceptionally bad winter storms. Demand in the key sectors that had led the decline--housing and consumer spending--showed some signs of leveling off as the year began, and the recent cuts in production likely have helped to relieve some of the remaining inventory imbalances. Recent weather-related disruptions may affect the incoming data for a time, but it would appear that the economy is in the process of bottoming out, and a perceptible recovery in business activity seems likely before midyear.

One element supporting final demands in the economy is the federal government. Part of the recent expansion in the deficit reflects the cushioning effects of reduced taxes and increased government expenditures that result from declining income growth and rising unemployment. In addition, however, the build-up in defense spending is a continuing source of stimulus. The second phase of the tax reductions that occurs in July will provide another expansionary impetus to the economy. At the same time, the deficit--particularly if expected to continue at exceptionally high levels in later years--adversely influences current financial market conditions.

The Federal Reserve's objectives for money growth in 1982 are consistent with recovery in economic activity. The expansion is likely to be concentrated initially in consumer spending. Given the substantial margin of excess capacity, outlays for business fixed investment may remain weak, particularly if long-term interest rates continue to fluctuate near their current high levels. A continuation of high levels of long-term rates also

would inhibit the recovery in residential housing, although demographic factors will continue to buttress demands in that sector.

The effort to deal with inflation is at a critical juncture. The upward trend in inflation clearly has been halted and the process of reversal is underway. There are signs that price setting, wage bargaining, and personal spending decisions are beginning to be made that over time will serve to moderate, rather than intensify, inflationary pressures. Nonetheless, the behavior of financial mar ts and other evidence strongly suggests that there continues to be considerable skepticism that progress in reducing inflation will be maintained. Lasting improvement in financial markets--particularly for longer-term instruments--is dependent on confidence that progress against inflation will continue; looming federal deficits have served to shake that confidence. Prospects for lower interest rates and for sustaining recovery over a long period--indeed for the timing of recovery--are thus tied to prospects for a more stable price level.

How we emerge from the current recession will be crucial to further curtailing inflation. The recovery phases that have followed recent recessions have sometimes been associated with an acceleration of inflation. However, if monetary and fiscal policies are appropriately disciplined, this pattern need not recur; and recovery from the current recession will be consistent with further progress towards achieving sustainable growth, price stability, and lower levels of interest rates.

Given the current circumstances and in light of the monetary aggregate objectives for the coming year, the individual members of the FOMC have formulated projections for economic performance in 1982 that generally fall

within the ranges indicated in the table below. The members of the FOMC expect inflation to continue to moderate in 1982. At the same time, real activity is expected to accelerate with most of the growth coming in the second half of the year. With inflation continuing to be substantial and the prospect of the federal budget deficit remaining large even as the recovery gathers momentum, demands for credit should intensify as the year progresses. In these circumstances, the recovery is likely to be somewhat restrained, with the result that unemployment probably still will be substantial at year-end.

Economic Projections for 1982

| | Actual 1981 | Projected 1982 | |
|---|---|---|---|
| | | FOMC members | Administration |
| Changes, fourth quarter to fourth quarter, percent | | | |
| Nominal GNP | 9.3 | 8 to 10-1/2 | 10.4 |
| Real GNP | 0.7 | 1/2 to 3 | 3.0 |
| GNP deflator | 8.6 | 6-1/2 to 7-3/4 | 7.2 |
| Average level in the fourth quarter, percent | | | |
| Unemployment Rate | 8.3 | 8-1/4 to 9-1/2 | 8.4 |

The FOMC member's projections generally encompass those that underlie the Adminstration's recent budget proposals. The consensus view of the FOMC anticipates an improvement in inflation during 1982 comparable with the Administration's as well as a similar outlook for the labor market. The Administration's projection for real growth falls at the high end of the FOMC consensus. If, in the event, prices and wages should respond more rapidly to anti-inflation policies than historical experience would suggest or should more favorable productivity trends develop, then the recovery could be faster without adverse pressures developing on prices, wages, and interest rates.

Chairman Volcker subsequently submitted the following responses to questions from Senator Heinz in connection with the hearing held before the Senate Banking Committee on February 11, 1982:

Question No. 1: Have wire transfer and money market funds expanded the marketing of U.S. savings to foreign customers?

Answer: U.S. money market funds hold about $22 billion of deposits at foreign branches of U.S. banks, mostly in the form of negotiable Eurodollar certificates of deposit. Foreign branches have used funds raised from these deposits to help finance their overall banking operations. Such deposits have been increasingly important sources of funds to foreign branches over the past few years--in part substituting for financing obtained from U.S. offices. In 1981, net financing by U.S. banks of their foreign branches was reduced by about $5 billion, and in addition the branches extended credits amounting to almost $10 billion to nonbank customers in the United States. As the question implies, the development of wire transfer facilities has improved the ability of money market funds to offer attractive services.

Question No. 2: Is the demand for U.S. savings asserted from abroad affecting availability of funds and the interest rates in the United States?

Question No. 7: Does foreign demand for U.S. savings have an impact on U.S. residential mortgage rates to the extent that foreign demand for U.S. savings drives up mortgage rates in the U.S.?

Answer. U.S. international transactions on merchandise trade and services (the current account) have been roughly in

balance in the past three years, indicating a near balance in the capital account on a net basis. Within this net balance there have been sizable increases in U.S. private assets abroad (capital outflow) and in foreign assets in the United States (capital inflow). The latter includes a new inflow on unidentified transactions, which may in part represent foreign credits to U.S. residents that are not recorded in our statistics.

This net balance on capital account is the most appropriate statistical measure of the extent to which the United States is a net exporter or importer of savings. As noted above, the United States has not been investing substantial amounts abroad on a net basis in the past three years, and in 1977 and 1978, the United States had deficits on current account, which were financed through net foreign investment in this country.

More generally, net capital flows to or from abroad (less than $10 billion annually in recent years) are relatively small compared to total U.S. credit flows ($400 billion in 1981), and net foreign demand for funds would not be expected to have a significant effect on interest rates or overall availability of credit in the United States. Thus, foreign demand does not appear to be a significant factor affecting U.S. mortgage rates.

Question No. 8: Does this adversely affect the economic recovery in the U.S. and the flow of revenue to the Treasury?

Answer: Economic recovery would be assisted by an increase in U.S. exports and an improvement in our current

account position, and recovery would contribute to U.S. Treasury revenues. However, the outlook is for rising U.S. current account deficit. As noted in the answer to questions 2 ans 7, this deficit would be associated with a rise in the flow of net foreign investment into the United States.

Question No. 3: Are foreign governments borrowing directly in the U.S. through the issuance of bonds and notes? Are these bonds and notes being purchased by tax free pension funds?

Answer: Yes, foreign governments borrow directly in U.S. capital markets, as they have for many years. In 1981 bonds issued by foreign governments and businesses together represented less than 3 percent of total long term borrowing in the U.S. market in that year. Available information shows small holdings of foreign government securities by pension funds.

Question No. 4: Are foreign banks and businesses borrowing directly in the U.S. and is their debt being sold to pension funds?

Answer: Foreign banks and businesses (including government-owned businesses) do borrow in the United States through issuance of bonds and notes and of commercial paper. Foreign borrowing in the form of commercial paper has been growing, but it is still less than 10 percent of the total amount of commercial paper issued in the United States. Present information suggests that pension funds are not active purchasers of such short-term debt instruments.

Question No. 5: Are U.S. and foreign branches of Money Center Banks using certificates of deposits sold to money market funds as a source of funds for foreign loans?

Answer: Money market mutual funds currently hold about $45 billion in domestic CDs and approximately $22 billion in Eurodollar CDs. Since banks raise funds from a variety of sources and make loans to a wide range of customers, it is not possible to trace the specific uses of a particular source of funds to the banks. However, the following data can help put these figures in perspective.

As of September 1981, U.S. chartered banks held about $400 billion in total claims on foreigners, mainly in the form of loans and credits extended by their foreign branches. This is an amount six times as large as their sales of domestic office and Eurodollar CDs to money market mutual funds. Most of the funding for these foreign loans has come from foreign deposits and interbank borrowings from foreign banks.

Question No. 6: Is the consumer of shelter in the U.S. now competing in an international money market for the use of U.S. savings?

Answer: Over the last several years participation by U.S. residents in international financial markets has grown, and U.S. and international money markets have become more closely integrated. The closer integration of these markets has meant that all users of funds, including those who seek new mortgages, now compete for funds more actively than before. The more significant effect on the cost and availability of mortgage

credit in the U.S., however, has come from the effects of inflation on interest rates, especially long-term rates, and the greater competition and deregulation in our domestic financial system.

Question No. 9: Are foreign governments transferring their deficits and the expenses of their social programs to the U.S. economy by borrowing in the U.S. capital market and by borrowing from foreign branches of banks dollars raised in the U.S.?

Answer: Foreign governments finance budget deficits through borrowings in both domestic and foreign markets. Generally, the amount of governmental borrowing undertaken in external markets is related to the external position of the country in question. A country with a large deficit on current account (perhaps attributable in part to sizable purchases of oil) will have to borrow abroad net in order to finance the current account deficit if it is to avoid drawing on its international reserves; some of the external borrowing may be private and some may be governmental.

Foreign governments borrowed $10 billion in 1981 from U.S. banking offices compared with $7 billion in 1980. (Their total borrowing from foreign branches in the two years combined was about $1 billion.) These figures are small in relation to the aggregate budget deficits of the borrowing countries, and also small in relation to the total external borrowings of these countries. Foreign governments have also borrowed relatively small amounts in U.S. capital markets. Net U.S. investment abroad in 1980 and 1981 increased by less than the above-cited figures on foreign government borrowings, reflecting net capital inflows on other transactions.

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Chairman Volcker subsequently submitted the following responses to questions from Senator Riegle in connection with the hearing held before the Senate Banking Committee on February 11, 1982:

Question No. 1: Mr. Chairman, you are quoted in this morning's Wall Street Journal as desiring to continue "a steady trend of diminution" in growth of the money supply in order to reduce inflation. If this is your long term objective wouldn't it be desirable to have a 3-year target for money growth rather than a 1-year target?

Wouldn't that create greater stability--if your long run goals were numerically explicit?

Answer: As you noted, I believe that money growth must moderate over a period of time in order to achieve a lasting reduction in inflation. However, I do not think that it would be wise for the Federal Reserve to establish or announce numerical goals it would pursue for several years into the future to achieve this goal. Within the context of a basic policy to slow money growth, the Federal Reserve needs to maintain flexibility in setting each year's targets for monetary expansion so that it can adjust for developments in the economy and financial markets. For example, innovation in financial instruments and practices in our economy, that is, in the way people choose to hold their money, makes it difficult to formulate monetary targets over extended periods that can be relied on confidently to achieve their intended effects. If multi-year targets were established, inevitably it would be necessary to revise them if financial practices evolved (in response to changing incentives or regulations), a process that could confuse the public about the basic thrust of monetary policy.

Question No. 2: What would be the practical and economic consequences of following the type of stable money growth policy--week-to-week--desired by Mr. Regan and Mr. Sprinkel? Would interest rates behave differently? Would real economic activity be affected?

Answer: Efforts to achieve stable week-to-week or even month-to-month expansion in money growth would in my view give rise to even more sizable short-term swings in interest rates than we are now experiencing. The Federal Reserve recognizes that money stock growth has been volatile over short periods, and we are constantly reviewing suggestions for changes in our techniques or regulations that would help improve our control over money. For each suggestion, we weigh the gains from the potential for greater stability of short-run money growth against the possible drawbacks to financial markets or the economy. The weekly money stock numbers are a highly erratic series, subject to substantial revision, heavily influenced by uncertain adjustment f seasonal patterns, and influenced by a variety of short-term factors, including shifts in demand for money, that often are subsequently reversed. To force this series to follow a rigid path might necessitate wrenching adjustments in financial markets to counteract inherently short-term fluctuations. Moreover, movements in money generally must persist for some period of time to have a lasting effect on economic activity or inflation, so there would seem to be little to be gained in terms of improved performance of the economy from strict adherence to a fixed weekly or monthly path for money.

Question No. 3: It is my understanding that you have a choice of controlling money growth or short term interest rates, and that prior to October 1979 you paid more attention to interest rate stability. Have your new procedures helped to stabilize overall economic performance? What effects have they had on the real--as opposed to the financial economy?

Answer: October 1979 did not mark a change in the targets the Federal Reserve was trying to achieve; both before and after that date we were trying to meet our nation's economic goals by attaining growth rates for the monetary aggregates within specific target ranges. Prior to October 1979, however, we were attempting to attain our money stock targets by manipulating short-term interest rates; since then we have put primary emphasis on changes in the volume of bank reserves to achieve our money stock objectives. The former method did tend to be associated with fairly smooth patterns of short-run movements in money market interest rates, but it also tended to produce growth in money and credit that sometimes deviated appreciably from Federal Reserve intentions. The new technique increases the probability that the Federal Reserve will achieve its money growth objectives, but at some cost in greater short-run volatility of interest rates.

The effects of the Federal Reserve's new operating procedures on aggregate economic activity are difficult to assess. Many other factors have also had an important impact on activity in the last two years, and it is not possible to separate the effects of one or another of these influences. By speeding the response of interest rates to changing conditions in the economy the new procedures should help to damp fluctuations

in economic activity--allowing rates to decline more rapidly when conditions weaken and to pick up faster as the economy expands. The new procedures have contributed to the welcome slowing in inflation we have experienced in recent months because they have enhanced the Federal Reserve's ability to achieve desired money growth. Further moderation in cost and price pressures will be necessary to establish the non-inflationary environment that is a precondition for sustained growth in economic activity. By making progress toward this goal more likely, the new techniques contribute to enhancing our prospects for sustained growth in incomes and living standards.

Question No. 4: Mr. Chairman, monetary policy has had rather severe effects on housing and autos and the types of products that are complementary to them. Manufacturing capacity is now at 73 percent. Unemployment is at 8.5 percent. We have some evidence that from July to December of last year while the number of jobs in goods-producing industries declined, the number in service industries actually increased. A pattern similar to this--decreasing jobs in goods and increasing jobs in services--occurred during each of the previous three recessions.

Does your analysis of the intended effects of monetary policy on the economy--your judgment or your models--take into account the structural shift in the economy from manufacturing to services? Does tight monetary policy have the same effects on goods production as on service production?

Answer: In analyzing the effects of monetary policy on the economy, the Federal Reserve pays close attention to the varying responses of different sectors of the economy. As you noted, goods-producing industries have experienced much wider swings in activity than service industries through recent business cycles--expanding more rapidly in upswings and contracting more severely in recessions. In the case of recessions, for example, when consumers experience sluggish income growth, they postpone purchases of many goods to the extent they can continue to use previously purchased items; consumption of most services generally cannot be so readily put off. Second, houses and durable goods are more often purchased on credit than are services, so that the rise in interest rates that often occurs as inflation accelerates in the late stages of a business cycle tends to discourage subsequent sales of these goods relative to services. Because of their sensitivity to interest rate movements, goods-producing industries have been especially affected in recent years by the over-reliance on monetary policy to curb inflationary pressures. A more balanced policy mix that included a less expansionary budget posture would help moderate interest rate pressures and permit the burden of reducing inflation to be borne more equitably by different sectors of the economy.

Question No. 5: Why are interest rates so much higher now than they were in 1975-76 when the deficit as a percentage of GNP was about the same?

Answer: One important difference between 1975-76 and the current situation is the outlook for federal government borrowing in the foreseeable future. Although the deficits in the earlier periods were very high, there was every expectation that they would decline substantially as the economy resumed expansion. In contrast, today many are predicting even higher budget deficits for coming years even on the assumption of a resumption in economic growth. Concern that massive federal government borrowing will continue even as private credit demands once again begin to climb as a result of economic recovery has contributed significantly to the current elevated level of interest rates, especially long-term rates.

A second difference is in investor attitudes towards future inflation. Currently, investors have not yet been convinced that we have made lasting progress against inflation--that a reemergence of price pressures will not occur in association with renewed economic growth. This skepticism was not as evident in the mid-1970s, and stems I believe largely from past developments when gains against inflation were subsequently reversed, and the pace of price increases rose to new heights. Because of this experience, savers and borrowers apparently do not believe that the government will carry through on its anti-inflation policies. Lasting declines in interest rates therefore seem to require that we demonstrate our intention to persist on our policy course. In this context, a more responsible budget policy would help to reduce rates both by directly reducing actual and prospective credit demands and also by demonstrating that all facets of economic policy were working towards the same goals.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

PAUL A. VOLCKER
CHAIRMAN

March 11, 1982

The Honorable Jake Garn
United States Senate
Washington, D. C. 20510

Dear Senator Garn:

As promised during my February 10 appearance before the Senate Banking Committee, I've attached a staff evaluation of the column by Milton Friedman that appeared in the February 15 issue of Newsweek. Hope this proves helpful to you.

Sincerely,

Paul A. Volcker

Evaluation of Friedman Newsweek Column
Thomas D. Simpson

In assessing variations in narrow money growth in recent years it is important to note that the narrow money stock has been subject to a number of highly unusual influences. In particular, M1 contracted sharply following the imposition of credit controls in March 1980 and later rebounded. Contributing to this pattern was a large contraction in money demand stemming from the drop in income and the subsequent jump in money demand associated with the resurgence of income following the removal of credit controls. In addition, growth in M1 over the first several months of 1981 was raised significantly by the new availability of NOW accounts nationwide as the public shifted balances from savings accounts and other non-demand deposit sources to newly-opened NOW accounts. More generally, money demand is highly volatile, especially over short periods of time, and in recent years there have been times during which sustained downward shifts in the demand for transactions deposits have occurred, reflecting more intensive application of sophisticated cash management techniques.

A number of measures are suggested by Mr. Friedman to reduce variability in monetary growth. These are: adopting contemporaneous reserve requirements; selecting a single monetary target; imposing equal reserve ratios on the monetary aggregate to be controlled; linking the discount rate to a market rate; and reducing defensive open market operations. An evaluation of each of these measures follows:

1. <u>Contemporaneous reserve requirements (CRR)</u>. This proposal has the potential for strengthening the relationship between reserves and the money stock in the very short run of a week or month. Departures of money from path would give rise to more immediate pressures in the reserves market that would more promptly tend to return the money stock toward path. However, the degree

of improvement offered by CRR is open to dispute among experts and would be heavily dependent upon whether it was combined with other changes, such as those listed below. Potential gains in monetary control from adopting CRR alone can be exaggerated, and lead to unwarranted assumptions as to its effectiveness. Over a longer period of time, such as a quarter or more, the contribution of CRR to monetary control would likely be smaller. The Board has expressed a disposition to return to CRR--pending investigations of its feasibility--and soon will take up this matter again.

2. A single monetary target. In view of the vulnerability of the various monetary aggregates to highly unpredictable influences in an era of rapid financial change, focusing on just a single measure of the money stock would lead to much different outcomes for financial markets and the economy depending on the measure selected. For example, in 1981 M1-B adjusted for shifts to NOW accounts ran below the lower end of its target range over most of the year, while M2 and M3 ran at or above the upper end of their ranges. The weakness of M1 in 1981 is believed to reflect extraordinary efforts by the public--in response to high interest rates--to streamline procedures for managing narrow money balances. Unusually rapid growth of M2 was in part related to the sharply rising share of this measure having market determined yields. Efforts to restore M1 growth to its range likely would have been associated with both even faster M2 and M3 growth and adverse expectational effects, while efforts to ensure that M2 and M3 growth fell within their ranges would have been associated with a larger shortfall of M1 and tauter financial conditions.

3. A single reserve ratio on the aggregate to be controlled. It is widely agreed that a single reserve ratio on deposits in the monetary aggregate to be controlled and no reserve requirements on other deposits would reduce slippage between the supply of reserves and this aggregate. The Monetary Control Act

represents an important step in the direction of improving control over the narrow money stock by establishing uniform reserve requirements on the transactions deposits of all depository institutions--3 percent on an initial reserve tranche ($26 million per institution in 1982) and 12 percent on all other transactions deposits. By the terms of the Act, depository institutions are phasing in over time to the new reserve structure, and thus uniformity will be achieved when this phase-in process has ended. In addition, the Board is given authority to lower to zero the reserve ratio on other liabilities.

4. Linking the discount rate to a market rate. The discount rate in relation to market rates affects the willingness of depository institutions to borrow reserves from the discount window and, in the case of a nonborrowed reserves operating target, the overall supply of reserves and the money stock. In view of administrative constraints on borrowing and a general reluctance of depository institutions to borrow reserves from the discount window, linking the discount rate to an open market rate could, with a nonborrowed reserves operating target, lead to much sharper swings in interest rates and the money stock. An expansion in reserve needs of depository institutions that was not met through open market operations, for example, would lead to more intensive bidding for reserves in the reserves market--as institutions initially attempted to avoid turning to the window--and the federal funds rate and other money market rates would rise. Higher money market rates according to the formula would lead to a higher discount rate which would put still further upward pressure on money market rates and so forth. Such a policy would run the risk of excessive ratcheting of the rate structure upward and downward in response to temporary disturbances to money demand or supply side shocks and of contributing to cycles in the money stock.

With a total reserves or monetary base operating target, changes in the willingness to borrow reserves would not affect the supply of total reserves as

changes in borrowed reserves would, in concept, be offset completely by open market operations. Thus, with a total reserves or monetary base target pressures in the reserves and money markets and monetary control would be about the same regardless of discount window policy. With a total reserves or monetary base target, though, interest rate volatility would be greater as highly volatile money demand movements would be reflected more fully in interest rate fluctuations.

5. Reduce defensive open market operations. Defensive open market operations are intended to minimize the impact on the supply of reserves of fluctuations in noncontrolled factors affecting reserve supply, such as Federal Reserve float and Treasury deposits. In the absence of such defensive actions, the supply of reserves would fluctuate widely on a day-to-day and week-to-week basis, thereby causing fluctuations in the stock of money and money market condtions.

The measures suggested by Mr. Friedman would lead to more variability in interest rates. Their influence on the precision of monetary control would, on balance, be uncertain, over a longer horizon of a quarter or so, although control might be improved in the short run. In general, measures to strengthen monetary control in the short run, such as adoption of CRR and more emphasis given to controlling total reserves, would also give rise to larger fluctuations in interest rates, reflecting the highly volatile nature of money demand in the short run.

# The Yo-Yo Economy

MILTON FRIEDMAN

The present recession is notable not for its severity, but for its timing. Its onset cut short an expansion that had lasted only twelve months (from July 1980 to July 1981)—the second shortest expansion in the more than 100 years of U.S. history for which economists have dated business cycles. Moreover, that expansion followed the shortest recession on record—the six-month recession that lasted from January to July 1980. If the current recession also proves to be brief—as most economic forecasters anticipate—we shall have experienced by far the shortest triplet of recession-expansion-recession.

**Gyrating Interest Rates:** What accounts for this unprecedentedly erratic behavior of the U.S. economy? The answer that leaps to mind is the correspondingly erratic behavior of interest rates. Short-term interest rates had already hit historic highs in 1979. In the next two years, the rate on three-month Treasury bills bounced up and down between a high of nearly 17 percent and a low of a trifle over 6 percent—gyrations without precedent during the more than a century for which we have data.

What produced the unprecedented volatility in interest rates? The accompanying table suggests the answer: unprecedented volatility in monetary growth. The first part of the table updates one that I recently published in my column (NEWSWEEK, Dec. 21) and records the volatility in monetary growth. The second part shows what happened to short-term interest rates some weeks after each up and down of the monetary yo-yo. The evidence is dramatic. Four out of five surges in the quantity of money were followed by a rise in the Treasury-bill rate; all five declines in the quantity of money were followed by a decline in the bill rate. It is notable also that the one exception—after the Sept. 16, 1981, peak in monetary growth—followed the smallest rise in monetary growth.

The yo-yo swings in monetary growth affected the economy directly, as well as through interest rates. Each surge in monetary growth was followed after some months by an acceleration in spendable income, output and employment; and each decline in monetary growth, by a retardation. Consider the following pattern, which averages out some of the gyrations:

**1.** From Oct. 3, 1979, to April 30, 1980, $M_{1\text{-}B}$ (currency plus checkable deposits, now relabeled $M_1$) declined at an average annual rate of .2 percent. A cyclical recession came three months later, from January 1980 to July 1980.

**2.** From April 30, 1980, to April 22, 1981, $M_{1\text{-}B}$ grew at the annual rate of 9.9 percent. A cyclical expansion came three months later, from July 1980 to July 1981.

**INTEREST RATES FOLLOW MONEY**

| Money Turning Point | Date | Interval in Weeks | Annual Rate of Change in $M_{1\text{-}B}$ | Three-Month Treasury Bills: Three Weeks Later | Four Weeks Later | Five Weeks Later |
|---|---|---|---|---|---|---|
| Peak | Oct. 3, 1979 | | | 12.6% | 12.1% | 12.3% |
| Trough | Nov. 28, 1979 | 8 | -1.4% | 12.1 | 12.0 | 12.1 |
| Peak | Feb. 20, 1980 | 12 | +12.1 | 15.3 | 14.8 | 15.6 |
| Trough | April 30, 1980 | 10 | -12.4 | 8.2 | 7.7 | 7.5 |
| Peak | Nov. 26, 1980 | 30 | +15.0 | 16.2 | 14.6 | 14.3 |
| Trough* | Feb. 4, 1981 | 10 | -13.1 | 14.2 | 14.4 | 13.8 |
| Peak | April 22, 1981 | 11 | +23.8 | 16.8 | 16.6 | 15.6 |
| Trough | July 1, 1981 | 10 | -10.6 | 15.5 | 15.1 | 15.4 |
| Peak | Sept. 16, 1981 | 11 | +7.2 | 13.8 | 13.4 | 13.4 |
| Trough | Oct. 28, 1981 | 6 | -5.1 | 10.3 | 10.2 | 10.4 |
| Peak | Jan. 13, 1982 | 11 | +24.6 | 13.2† | | |

* Corrected roughly for NOW accounts    † preliminary

Joseph M. Arena—Newsweek

**3.** From April 22, 1981, to Oct. 28, 1981, $M_{1\text{-}B}$ declined at the annual rate of 1.3 percent. A cyclical recession started three months later, in July 1981.

If this pattern continues, and the monetary explosion from Oct. 28, 1981, to Jan. 13, 1982, is not followed promptly by a decline of comparable size, this recession too will be a short one. Indeed, it may already have passed what will subsequently be recognized as a trough.

As in a good mystery story, we now know what happened but not yet who—or, in this case, what—triggered these developments. The crucial clue is given by the dating. The unprecedented volatility of the money supply followed the Federal Reserve's Oct. 6, 1979, announcement of a major change in its operating procedures. The objective of the change—to move from operating through an interest rate to operating through bank reserves—was welcomed by many of us. Unfortunately, however, the actual changes in procedures, though far-reaching, did not go far enough to enable the new procedures to produce the desired results. As I noted in my earlier column, it was one step forward, two steps backward.

The technical steps needed to end yo-yo monetary growth are well known and the Fed has the authority to take them. They have the support of most monetary economists inside and outside the Federal Reserve System. They include: replacement of lagged reserve accounting by contemporary reserve accounting; selection of a single monetary target to replace the Fed's juggling between targets, depending on which one gives the most favorable picture of Fed policy; imposition of equal percentage reserve requirements on all deposit components of the selected target; linking the discount rate to a market rate; reduction in the churning that the Fed engages in (so-called "defensive open-market operations").

**Lip Service:** The Fed knows how to produce more stable monetary growth. The problem is that, despite the lip service that they pay to that objective, the key policymakers of the Fed do not regard the achievement of stable monetary growth as sufficiently important to justify the bureaucratic disruptions required.

Most discussions of monetary policy center on whether policy is "too tight" or "too easy." That is not my complaint. Average monetary growth over the past two years has been fairly good—decidedly lower than earlier. That is why inflation has been declining. However, the average conceals the erratic alternation of "too tight" and "too easy." That alternation has put the economy through a dismaying roller coaster. It must be replaced by steady monetary growth in order for the Fed to regain the confidence of the financial community and for President Reagan's economic program to succeed in both ending inflation and providing a stable basis for healthy, noninflationary economic growth.

# FEDERAL RESERVE'S FIRST MONETARY POLICY REPORT FOR 1982

THURSDAY, FEBRUARY 25, 1982

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
*Washington, D.C.*

The committee met at 9:30 a.m. in room 5302, Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

The CHAIRMAN. The Banking Committee will come to order. We don't have our witnesses yet, but that doesn't stop me from starting the committee on time and breaking my own unbroken record of being punctual.

Mr. Schechter, would you like to come up and start your testimony? You are on the second panel but you're here on time and I see no reason why you and I should wait. Is either Mr. Sumichrast or Mr. McKinney here? Mr. McKinney, will you come up, too?

We are happy to welcome you two gentlemen here not only on time but way ahead of your time scheduled to speak. Mr. McKinney, would you like to begin?

## STATEMENT OF GEORGE W. McKINNEY, JR., SENIOR VICE PRESIDENT, IRVING TRUST CO., NEW YORK, N.Y.

Mr. MCKINNEY. Well, we are pleased and honored to be here, sir. I will have to find my piece of paper before I begin but I've got it.

[Complete statement follows:]

PREPARED STATEMENT BY GEORGE W. MCKINNEY, JR., SENIOR VICE PRESIDENT IRVING TRUST CO., NEW YORK CITY

Mr. Chairman, members of the Committee. I am George McKinney, senior vice president, of the Irving Trust Company, New York City, and chairman of the bank's Economic Advisory Committee.

One subject for comment today is Federal Reserve policy since mid-1981. In my opinion, the Federal Reserve has done an unusually fine job in a very difficult environment. Inflation has slowed markedly and will likely improve even more. The Federal Reserve's actions have been critical in achieving that result. The Federal Reserve is to be particularly commended for not trying to fine-tune money growth.

The Federal Reserve started moving to an easier money policy last summer, just about the time the recession got under way. M1 growth was sluggish, and the Federal Reserve wanted to get it back on track. Policy eased progressively but moderately until near year-end, when money growth picked up again. In spite of the Federal Reserve's moderate actions, though, money growth surged in December and January. Again, the Federal Reserve took the appropriate course of moderation. Instead of slamming on the credit brakes and forcing interest rates to much higher levels, it chose to move gradually, to tolerate for a while what appeared to be a temporary aberration. The sizeable decline in M1 reported last week gives supportive evidence that the right decision was made.

The Federal Reserve could have taken a more extreme, doctrinaire course by trying to fine-tune money growth. Visualize what would have happened, though, if the Federal Reserve had tried to force money growth to stay in a narrower range throughout this period: Last fall, at a time when rates were already dropping from the 18 percent range to the 12 percent range, a fine-tuning policy would have called for aggressive ease. When money growth subsequently speeded up, and moved above targets, as it did anyway, fine-tuning would have required very aggressive tightening.

The result would have been more severe disruptions in financial markets, a much sharper decline in interest rates than actually occurred, a subsequent very sharp rise in rates to levels well above where they are now. There's no way that such a policy could have benefited the economy. In fact, the uncertainties engendered by such extreme market instability probably would have caused businessmen to cut back more sharply on their investment plans, and the present recession would likely be deeper than it is. The prospects for recovery would be less favorable.

Throughout this period, the Federal Reserve has followed a consistent course of moderate, tenacious resistance to inflation. That program was well conceived and has been well executed.

## MONETARY STRATEGY FOR 1982

Circumstances severely limit the Federal Reserve's options in setting and pursuing policies today. The fight against inflation is one that must be pursued steadily over a period of years. Of course there should be room for flexibility, for give and take in the execution of policy as business and financial conditions change. But that flexibility must be structured around a basic, continuing policy of moderate restraint.

## FISCAL POLICY CONSIDERATIONS

Such a policy of restraint would be more effective if it were accompanied by a less expansionary fiscal policy. Large structural deficits threaten severe damage to the economy, and the most enlightened monetary policy can't prevent it.

Let me distinguish between structural deficits and those that are caused by recessions. A substantial part of the near-term deficit now in prospect will happen purely because of the recession. Government tax receipts will fall because incomes are off; public benefit outlays will rise because more people are out of jobs. Such recession-induced deficits should not be cause for concern. They cushion the impact of the recession, and then they go away when the recession is over. Most of the 1982 deficit will be due to the recession. That is not the deficit I'm talking about.

The real problem is the structural deficits—those that are caused by overt policy actions, deficits that will be around in 1983, 1984, 1985, after the recession is behind us. Those deficits threaten serious harm to the Nation's economy.

The conflict between a moderately restrictive monetary policy, necessary to combat inflation, and heavy Federal borrowing to finance the deficit sets up an unavoidable sequence of events that compresses the business cycle, shortens and intensifies it. We are looking at the results right now: high and volatile interest rates, cash flow problems for thrift institutions and other industries, rising bankruptcies, rising unemployment.

Large Treasury deficits take a big share of the total funds available in credit markets. Funds raised under Federal auspices took a third of the total last year, and will take something like that share again this year. That doesn't leave much room for private credit. Yet, if business is to expand, it must have funds to carry inventories and to finance capital outlays. Those growing private demands for credit have to be met from a supply of funds severely depleted by Treasury borrowing, so interest rates rise disproportionately. Rates quickly reach levels that make it too costly to finance inventories. Businesses liquidate the inventories, pull back on capital spending plans. Interest costs cut into cash flow so sharply that some firms go out of business. Production is cut back. Unemployment rises. That's the process that put us in the current recession.

Yet the deficit has another side. It adds to after-tax incomes of consumers and businesses as government pays out more than it takes in. Thus it stimulates spending. Sooner or later, this stimulus wins out over the inventory and capital spending cutbacks. Business begins to rebuild inventory, capital spending picks up. Borrowing needs increase. But, because the deficit soaks up so much of the available funds, interest rates rise disproportionately. And the stop-go business cycle starts over again.

Thus large structural deficits have two extremely damaging characteristics. They drive up interest rates and make them more volatile. They shorten the business cycle and make it more violent.

DEFICITS COULD SCUTTLE ANTI-INFLATION PROGRAM

The structural deficits now in prospect could thwart the Administration's resolve to slow government growth and stop the inflation. That could come about in either of two ways.

One: backlash. If short-run pain from high interest rates and high unemployment gets too bad, people may despair of ever being able to stop inflation, and vote for the old ways of demand stimulus. The result would be what we had in the 60s and 70s: accelerating inflation, unemployment stairstepping up to ever-higher levels, a nation progressively weakened by living off its own capital.

Two: large deficits and tight money could hold interest rates above expected profits for an extended period of time, causing a severely protracted recession or depression.

Interest rates will respond to the decline in the inflation rate, and when they do the change may be rather abrupt. But it doesn't always happen as quickly as we would like. Interest rates can be stubborn. Sometimes they give up current levels only reluctantly. It might be useful to review two periods when the inflation rate declined sharply, but the response of interest rates was quite limited.

First, the early 1920's. For the 3 years 1918-1920, inflation averaged a compounded 16.0 percent. Over the next 3 years, the average was minus 5.2 percent—a swing of 21.2 percent in the inflation rate. The decline in interest rates was much smaller. AAA corporate rates dropped from an average 6.12 percent in 1920 (the peak year) to 5.12 percent in 1923.

Results in the period after 1929 were similar. Inflation averaged a minus 1.1 percent from 1927 through 1929. By 1933, though, the three-year compound inflation rate was minus 8.1 percent—a decline of 7 percent in the rate of inflation. But interest rates declined very little, from 4.8 percent in 1929 to 4.5 percent in 1933—off only 0.3 percent.

Rates tend to decline reluctantly, even when the inflation rate declines sharply. Large deficits unnecessarily compound that problem by giving a further upward kicker to rates.

MONETIZATION OF DEFICITS

Deficits, when monetized by the Federal Reserve, are inflationary. If the government runs a deficit and the Federal Reserve, in effect, prints the money to finance it, inflation follows inexorably. If a deficit occurs because of an increase in, say, defense spending, the government spends more, but nobody else spends less. Or, if the deficit results from a tax cut, government spends the same and others spend more. It's the same principle.

But deficits can also be inflationary without any increase in the money supply. Money-substitutes can do anything that money can do, and money substitutes are growing fast these days. Credit cards, computer technology, money market funds, and other fast-breaking developments are making money, as we once defined it, nearly obsolete. Deficits financed by growth of these and other money substitutes are just as inflationary as those financed by money growth per se.

A recent study by Victor Kung, an associate of mine, gives statistical confirmation of the impact of deficits on inflation. At my request, Mr. Kung studied the relationship between Federal deficits and inflation over the past two decades. His study replicates the results of other studies that conclude that money is the most important single factor in inflation. With his econometric model, however, the five most recent quarters of Federal deficits (adjusted to remove the effects of recession-induced deficits) explain some 43 percent of all variations in inflation, without including money or any other factor as causal variables.

The implications for monetary policy are clear. The Federal Reserve cannot complacently assume that large deficits, even if they do not lead to faster money growth, are innocuous. To achieve a given degree of overall policy restraint, monetary policy must necessarily be tighter to the extent that fiscal policy is easy.

PUBLIC PERCEPTIONS ARE IMPORTANT

It has been said that the high level of current interest rates reflects two concerns in the financial community. Some fear that the Federal Reserve will revert to the

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inflationary policies of the past. Others are concerned about the need to finance large structural Federal deficits.

Two weeks ago, Banking Magazine put this question to the investment officers of the nation's commercial banks, at the annual meeting of the Bank Investments Division of the American Bankers Association. Of those who responded one way or the other, a majority of more than four to one felt that it was the prospects of large deficits, not a fear of monetary policy change, that was scaring the bond markets. They are convinced that the Federal Reserve will hold to its policies of moderate restraint. This group of active market participants probably gives fair reading of the level of concern in markets generally.

We cannot expect monetary policy to bring interest rates down to desired levels unless there is some reduction in prospective structural deficits. As long as the public is aware that deficits contribute to high rates, deficits will cause an upward bias in market rates. This fact, too, limits the Federal Reserve's policy options.

### PROPOSALS FOR TECHNICAL CHANGE

Several suggestions have surfaced recently, directed at technical changes to make it easier for the Federal Reserve to hit its money targets in the short run. Yet the basic assumption that short-run stability in money growth is achievable, and, if achieved, is desirable, is highly questionable.

The benefits that might accrue from the suggestions I have seen for technical adjustments have been highly overrated. While in theory some short-run benefits in precision of money control might be achieved, it is not clear that such a result would have any long-term benefits whatsoever. The economy responds to money growth only after a highly variable time lag, and money growth responds to Federal Reserve actions only after a variable time lag. Further, random fluctuations in money growth over short periods of time are considerably larger than the trend or the targeted rate of money growth. If, over time, money growth should vary from desired rates, the best policy is to move with deliberate caution to correct the unwanted variance. To move aggressively in response to what may be transient, unimportant movements in the money supply can be highly destabilizing.

### MANDATED FIXED TARGETS

One suggestion made recently is that the Congress should require the Federal Reserve to adhere to a fixed rate of money growth. This could prove to be a very serious error.

For one thing, "money" is continuously changing. If we had been able to define money perfectly 100 years ago, or 5 years ago, that definition would not hold today. Financial markets are changing too rapidly. A long list of money substitutes serve the functions of money today but didn't even exist a few years back. Specific targets for money are almost certain to be obsoleted by technological change.

If, for example, a money target had been mandated in 1860, it would quite likely have excluded checking accounts, which were then little in evidence. To have forced expansion of currency and coin to meet pre-ordained targets at a time when unanticipated growth of new checking accounts was meeting the nation's needs for transactions balances would have been highly inflationary.

Or, if Congress had required a fixed money target beginning in 1979, the most likely candidate for control would have been the old definition of M1, which excluded NOW accounts. Yet it would have required a colossal expansion of credit to keep money (by that definition) in its target range in 1981, because of the transfer of huge amounts from regular checking accounts to NOW accounts. In both instances, mandated targets set in good faith would have forced an enormous monetary inflation, because of the continuing evolution of money.

Mandatory targets would not remove the need for discretion in monetary policy; they would merely transfer policy discretion from the Federal Reserve to the Congress. Because money functions change, no fixed target can be set that would always be a useful target. Discretionary changes will have to be made from time to time. If the Federal Reserve is not permitted to make those changes as the need arises, then the Congress as a body will have to do it.

However, the Congress is too large to make timely changes. It is not well constituted to deal with the continuing day-to-day responsibility for specific monetary policy. That should continue to be delegated to the central bank, under the supervision of the Congress. The Federal Reserve is well designed to keep monetary policy free from short-run or narrow-interest political pressures. That purpose is being well served and should be continued.

MONETARY POLICY CHOICES FOR 1982

No matter what policies the Federal Reserve follows, interest rates are likely to be relatively high and volatile as long as the outlook is for large, sustained structural Federal deficits. Any significant relaxation of monetary policy under these conditions would set off another inflationary spiral. And it would be much harder to get the next spiral under control than to keep the present policies in effect while they are getting results. Yet, as the deficit crowds private borrowers out of the market, continued slowing of money growth is likely to trigger frequent recessions and will slow real growth.

The choice is difficult, but obvious. Continued moderate monetary restraint will subject us to intermittent short-run economic problems. But it will also slow the inflation and set the stage for sustained real growth in future years. That is the only policy stance the Federal Reserve can really consider. What does that imply for targets?

In the long run, the Federal Reserve and the Congress to which it reports should try very hard to find some way to break away from rigid money targeting. Markets have become so sensitized to money growth data that random swings and seasonal aberrations elicit exaggerated, destabilizing reactions. It would be far better to target nominal GNP, total credit, or perhaps some other broad objective.

In the short run, though, there seems to be little choice other than to select a money target and adhere to it—with a considerable amount of discretion. A wider target range would give the Federal Reserve leeway needed to adjust policies to changing financial and economic conditions in the course of the year, and should be considered. Thus I conclude that, with the exception of broadening the target bands, the targets proposed by the Federal Reserve seem quite appropriate for today's economy.

The CHAIRMAN. Thank you very much, Mr. McKinney. I appreciate you filling in. If both of you would just continue to sit there at the table, our first panel is now here. Secretary Sprinkel and Mr. Jordan, if you would like to come up and occupy these two chairs. Beryl Sprinkel, would you like to proceed with your testimony?

## STATEMENT OF BERYL SPRINKEL, UNDER SECRETARY FOR MONETARY AFFAIRS, DEPARTMENT OF THE TREASURY

Mr. SPRINKEL. Thank you, Mr. Chairman. I apologize for being 5 minutes late. We ran into an unanticipated traffic jam.

The CHAIRMAN. I understand that. You would not anticipate a Senate committee starting on time, so I'm not critical. Usually you could be 20 minutes late and not have missed anything, but not with this committee.

Mr. SPRINKEL. I understand that. If I have your permission, I will submit the complete text for the record and present a shorter version.

The CHAIRMAN. Certainly. Mr. Schechter and Mr. McKinney, your full statements will be placed in the record also.

[Complete statement of Mr. Sprinkel follows:]

### STATEMENT OF BERYL W. SPRINKEL, UNDER SECRETARY OF THE TREASURY FOR MONETARY AFFAIRS

It is a distinct pleasure to be here this morning to offer you the views of the Administration on monetary policy. While the Federal Reserve is an independent institution which is accountable to the Congress, the Administration considers monetary policy to be a crucial element in the economic recovery program. Without actions to ensure a steady moderate pace of monetary growth, inflation would continue to plague the economy, severely blunting efforts to restore growth of production and employment. As President Reagan stated last week, "I have confidence in the announced policies of the Federal Reserve Board." Their stated policy is gradual reduction in money growth.

While the various schools of economic thought often differ on the particular causes of inflation, I believe that all serious analysts would agree that inflation can

persist only when it is accommodated by monetary expansion. The policy implication is that the elimination of inflation requires that the rate of money growth must ultimately be reduced from the rapid pace of recent years to a level in line with the expansion of real economic activity. This is the foundation of the Administration's anti-inflation program and is the basis of the current policy of the Federal Reserve.

I reemphasize the point—a permanent reduction in the rate of monetary expansion is a necessary requirement for reducing inflation. The Administration also believes that a steady, moderate pace of money growth is sufficient to ensure long-run price stability. With a moderate pace of monetary expansion, the effect of factors—such as oil price shocks—that can cause temporary price changes, would not be translated into an ongoing general inflation. But even those who would rely less on monetary policy to fight inflation or, who argue that the current effort is too intense, recognize that any effort to control inflation ultimately requires, at a minimum, slower money growth.

We must keep this long-term requirement in mind as we consider the more immediate problems in the economy. The implementation of an effective anti-inflation program has been delayed for many years by continually focusing on immediate conditions and futile attempts to provide quick and painless solutions to stagflation. Ironically, the perceived costs of fighting inflation were not avoided, but instead only postponed, to grow larger each year. At last, we have an opportunity to make significant progress in permanently reducing inflation; and the key is to continue the effort to restrain the rate of monetary expansion.

The task of monetary policy is to reverse the rising trend of money growth that has produced similar trends of accelerating inflation and rising interest rates. This goal focuses, by necessity, on relatively long-term relationships, which unfortunately often appear to clash with concern for the immediate economic situation. The attention of the monetary authorities cannot be diverted, however, to providing short-term expedients. The focus must remain on reducing the trend of money growth.

Every journey must begin with the first step and the Federal Reserve took that step in 1981, holding the rate of money growth to 5 percent. If that step had not been taken last year, inflation would have become more deeply entrenched in the economy. In addition, the problems of unemployment and financial stress associated with moving to a noninflationary monetary policy would have grown larger. These are problems that must ultimately be faced—the longer we procrastinate, the longer inflation continues, the larger these problems become.

The Administration's support for the policy of reducing the trend of money growth is complete. It is of critical importance that the growth of money—M1—be held within the announced target range this year. In particular, concerns for the budget deficit should not interfere with actions to control money growth. The Administration does not expect the Federal Reserve to make any concessions on its monetary targets for the purpose of monetizing the deficit.

Deficits are not a monetary problem. Instead, the prospective government borrowing bears on the competition for savings in the economy. Budget deficits over the next several years would indicate excessive growth of government spending, which would be financed in competition with private investment. While we expect the supply of savings to increase sharply, allowing expansion of private investment, large deficits would, nevertheless, represent a substantial absorption of credit by the government. Thus it is important that the Administration and the Congress work together to restrain the growth of government spending, with the clear intention of balancing the budget.

We should recognize that the immediate or short-run effects of slower money growth are quite different from the ultimate impact. In the long run, slower money growth would result in less inflation, thereby reducing the growth of nominal income and the level of nominal interest rates. The transition to slower money growth—as we move from the excessive 8 percent growth of recent years to a noninflationary pace—can have temporary but substantial effects on real economic activity.

In a sense, the restriction of output and employment that we now feel is the inevitable payment for past monetary excesses. At the same time, however, it is possible to reduce these transitional costs and it is desirable to do so, since they involve the real burdens of unemployment and loss of income. Thus, a policy of achieving a noninflationary rate of money growth addresses half of the problem. Equally important is the way in which that policy is implemented.

The problem is that economic policymakers are not starting with a clean slate. We all wish that someone could wave a magic wand, wipe out the effects of past failures and allow the economy to start from scratch with the assurance that inflation is finished. Unfortunately, the effects of past policy failures are deeply imbed-

ded in all aspects of economic activity and that legacy has a dramatic effect on the public's reaction to current and future policy actions. In terms of monetary policy, the Federal Reserve faces the task of establishing the credibility of the policy to reduce the rate of monetary expansion.

Policy failures of the past are now a major factor determining the economic impact of current efforts to reduce money growth. Prior attempts to slow money growth over the past 15 years resulted in several short-lived periods of monetary restraint, but in each case money growth was subsequently reaccelerated to a higher, more inflationary pace. As a result, the immediate impact of monetary restraint on real economic activity—in terms of lost output and employment—has been intensified. In addition, the financial markets have become extremely sensitive to short-term variations in money growth as potential indicators of yet another monetary explosion. This sensitivity is reflected in high and volatile interest rates.

TRENDS AND FLUCTUATIONS OF MONEY GROWTH

The implications of current monetary policy and Federal Reserve policy actions are influenced greatly by the economic trends that have developed over the past several decades. As shown in the table below, the average rate of monetary expansion has accelerated steadily from the mid-1960's. This rising trend of money growth was associated with a similar acceleration in the average rate of inflation.

| | Percent of annual rates of change | | | Average unemployment rate |
|---|---|---|---|---|
| | $M_1$ | GNP deflator | Real GNP | |
| 1950 to 1965 | 2.7 | 2.2 | 3.8 | 4.9 |
| 1965 to 1970 | 5.0 | 4.2 | 3.2 | 3.9 |
| 1970 to 1975 | 6.1 | 6.5 | 2.6 | 6.1 |
| 1975 to 1980 | 7.1 | 7.2 | 3.7 | 6.8 |
| 1965 to 1980 | 6.1 | 6.0 | 3.2 | 5.6 |

Source: Council of Economic Advisers; Federal Reserve Bank of St. Louis.

Note, however, that persistent monetary stimulus did not result in lasting gains in output. Comparing the 15 years before and after 1965 reveals that average money growth and inflation more than doubled, while the average growth of output declined slightly. The average rate of unemployment was almost one point higher in the second period.

The relationship between money growth and economic activity has remained fairly constant, as indicated by the accompanying chart (Chart I). Growth of nominal income continues to be related closely to the pattern of growth of M1. Despite widespread financial innovations, which offer a variety of alternative types of deposits, the basic underlying demand for money in the economy continues to be satisfied by the narrow class of currency and deposits which comprise M1. We are confident that efforts to control the growth of M1 will be reflected in lower inflation and less variation in nominal income.

The reduction of money growth to a 5 percent rate in 1981 was just the first step; persistent action is required to reverse the trend of money growth and inflation over the next several years. The target for M1 growth which the Federal Reserve has adopted for 1982 is another step in that direction. Holding money growth to 5 percent again this year would consolidate the gains which have already been made and would ease the immediate costs of transition to a noninflationary path.

This moderate pace of money growth would provide the appropriate monetary environment for renewed economic expansion. It is not the cure-all for economic problems, but instead is the prudent next step in establishing a permanent, noninflationary rate of money growth, while contributing to an environment which encourages real economic growth.

As shown clearly in the table above, a secular acceleration of money growth did not give us more real economic growth. We should keep this in mind in considering the current economic recession. An effective anti-inflationary monetary policy will not require sustained or unrelenting restriction of output and employment. Reducing inflation and stimulating economic growth are mutually consistent goals.

The notion that relying on monetary policy to fight inflation necessarily involves an ongoing restriction of production and employment is based on a very short-sighted and incomplete view of economic relationships. Frequent references to the current situation are a case in point, but this situation is far from unique.

Monetary restriction in 1981 was a major factor contributing to the current economic recession. The slowing in money growth was abrupt and substantial, exceeding both the expectations of the Administration and the targets of the Federal Reserve. Given the prevailing trends, it was inevitable that such a sudden shift in money growth would have a significant depressive effect on real economic activity. While this effect involves real hardship for many sectors of the economy, it is, nevertheless, temporary and we would expect these depressive effects to wear off quite soon. This is part of the basis of our expectation that the economic expansion will begin this spring.

While some temporary restriction of production and employment is inevitable, given the persistence of inflationary trends of the past 15 years, the severity and duration of the restriction can be reduced substantially through prudent monetary actions. In formulating the economic recovery program, for example, the Administration opted for a gradual slowing of money growth over several years. We saw this approach as offering the economy time to adjust to a noninflationary environment. The inflationary experience had become deeply embedded in all aspects of economic activity—including wage negotiations and contracts, investment programs, financial contracts and international currency markets. We thought that moving abruptly to end inflation would probably result in severe short-term disruptions, as economic activity would have to be reordered quickly.

In addition to reducing money growth gradually, the costs of transition to less inflation can be reduced if money growth is slowed steadily and smoothly. Following years of volatile but ever-accelerating money growth, the financial markets are now very cautious of large changes in money, even on a weekly basis. While it is certainly true that such short-term fluctuations should have no economic meaning or effect, they do now have economic consequences because the financial markets react to them.

Sudden swings in money growth, which persist for several months, have therefore proven to be extremely disruptive to financial markets and the effect has spilled over into real economic activity. The most visible symptom of the disruptive effects of volatile money growth is high and volatile interest rates. While long-run monetary trends are ultimately the important consideration, short-term monetary fluctuations can be a potent force during the transition from an inflationary to a noninflationary trend of monetary expansion.

The problem is not that these very short term variations per se have fundamental effects on economic activity. Instead, their importance stems from the environment in which they occur. As shown by the experience in several foreign economies, variations in money growth can be absorbed with little disruption, once a basic noninflationary trend of monetary expansion is firmly established. Low inflation countries, such as Germany, Japan and Switzerland, have had smoothly declining monetary trends in recent years, even as they have experienced substantial short-term monetary variability.

The history of monetary actions in the United States since the mid-1960's is very different. As I have mentioned, prior efforts to control money growth were soon abandoned and rapid money growth was reestablished. The table below presents the major episodes of monetary restriction over the post-war period. Notice that each of the severe economic recessions was preceded by an abrupt slowing of money growth (column 2) and that this restraint was maintained into the recession (column 3). Typically, however, money growth was then increased sharply (column 4).

| Periods of recession | | Percent of annual rates of change of $M_1$ | | | |
|---|---|---|---|---|---|
| Peaks | Trough | Prevailing prior to recession [1] (1) | 2 quarters before peak (2) | 2 quarters after peak (3) | 4 quarters after trough (4) |
| 1948IV | 1949IV | 0.4 | −0.5 | −0.7 | 4.4 |
| 1953III | 1954II | 3.3 | 1.6 | 0.8 | 3.8 |
| 1957III | 1958II | 1.0 | 0.1 | −1.3 | 4.5 |
| 1960II | 1961I | 2.1 | −1.0 | 2.1 | 3.2 |
| 1969IV | 1970IV | 6.9 | 2.1 | 4.2 | 6.7 |
| 1973IV | 1975I | 7.9 | 4.9 | 5.3 | 5.7 |
| 1980I | 1980II | 8.2 | 5.8 | 5.4 | 9.9 |

[1] Rate of money growth during year-ended two quarters prior to peak in economic activity.

Prior to the mid-1960's, these cyclical variations in money growth had little effect on underlying monetary trends. Despite frequent and large variations, the money stock increased at an average rate of less than 3 percent from 1950 to 1965. Since 1965, however, the cycles of money growth have been around an increasing trend—the rate of monetary expansion following a period of restraint was typically faster than it had been prior to the restraint. Money grew 5 percent per year from 1965 to 1970, at more than 6 percent over the next 5 years, and accelerated to over 7 percent per year from 1975 to 1980.

The only exception to this cyclical pattern came after the 1973-75 recession. While money growth was increased somewhat following the recession, the pace was in line with the prevailing trend. As a result, the economic expansion was accompanied by general decreases in interest rates and an easing of inflationary pressure. In addition, this occurred despite a substantial increase in the Federal deficit. It was not until late in 1976 that the Federal Reserve began to inject money at a rapid pace, resulting in an 8 percent annual rate of money growth over the next four years.

This experience of a rising trend of money growth, punctuated by several periods of restraint, has had a profound effect on financial markets. The influence is evident in the markets' reaction to recent monetary variability. The cycles of money growth since the mid-1960's have been accompanied by similar cycles in long-term interest rates. Each period of monetary restraint led, after a short lag, to decreases in long-term interest rates. The evidence indicates that these decreases reflected easing of inflationary expectations. The subsequent monetary explosions, however, proved these expectations to be premature and long-term interest rates rose accordingly. The result was a series of cycles in long-term rates, with each low point at a level above the preceding low and each expansion leading to a new high in rates.

From this experience, the long-term credit markets have become very skeptical about the prospects for inflation, and thus interest rates, in the future. Each time that market conditions have generated downward pressure on long-term interest rates, a sharp acceleration of money growth aggravated concern about the impending monetary trends, leading to a rise in rates. While financial markets are well aware that trends in money growth are the dominant factor in inflation, experience has led them to doubt that several months of monetary restraint is a clear signal that the trend of money growth is downward.

This fear is evident in the markets' reaction to the surge in money growth that has occurred since October. On the one hand, the surge led to the expectation that the Federal Reserve would tighten money market conditions in an effort to restrain money growth. This concern causes short-term interest rates to rise. On the other hand, however, the persistence of the bulge in money growth has lent credence to the view that the restriction of money growth last year might be just another temporary downturn, to be followed by accelerated money growth, as in the past. This view has led to significant increases in long-term interest rates.

It is obvious that projections of the Federal deficit also play a role in this process. During periods of heavy government borrowing in the past, monetary actions designed to offset the resulting short-term pressures on interest rates contributed to rapid money growth. While both the Administration and the Federal Reserve are firm in their commitment to avoid monetization of the debt and to reduce the trend of money growth, the combination of history and the recent erratic swings in money growth have been sufficient to raise serious doubts in credit markets. These doubts are reflected in the level of interest rates.

These fears aggravate problems for specific sectors of the economy, which were already in considerable trouble. The continued problems of the housing and the automobile industries are a drag on the entire economy, and the persistence of high interest rates would seriously endanger the prospects for economic expansion.

The Federal Reserve can make a significant contribution to easing this problem through efforts to dampen the systematic variations in money growth, such as have occurred over the past two years. Random variations in money growth are to be expected and there is no reason to attempt to offset such changes. However, monetary actions can ensure that these random changes do not persist and lead to several months of either very rapid or very slow money growth. The accompanying chart (Chart II) shows the short-term growth of the money supply, as well as the monetary base, which is a summary measure of the actions of the Federal Reserve. As this chart illustrates, current control procedures have produced swings in growth of the monetary base which have caused and exaggerated variation in the money growth.

I believe that the variability of money growth would be reduced if the Federal Reserve targeted and controlled the monetary base, rather than the money supply.

While control of the base would certainly not remove the temporary and random changes in the money supply, it would take the Federal Reserve out of the difficult business of distinguishing between changes in money that are random and self-correcting and those that are not temporary and should trigger a policy response. Since growth of the monetary base is closely correlated with money growth in the long run, a moderate and steady rate of growth in the monetary base would be expected to produce a similar growth pattern for money. While the short-run fluctuations in money growth would still occur with steady growth of the base, these changes would tend to be self-correcting and would be canceled out quickly.

With a policy that provided for steady growth of the base, short-run fluctuations in money would not be answered with explicit policy actions. This would remove pressures on interest rates that now result from speculation in financial markets about how the Federal Reserve may react to a particular wiggle in the money data. An announced policy of steady growth in the base would reduce the uncertainty that now surrounds monetary policy and contributes to instability in the financial markets and volatile interest rates.

To complement a policy of controlling the base, I believe the Federal Reserve should eliminate lagged reserve requirements and tie the discount rate to a market interest rate so that it would be changed with market conditions. These administrative changes would improve the precision of the Federal Reserve's policy actions.

The ability of the economy to adjust to lower inflation would be enhanced by dampening the systematic swings in money growth. The transition to less inflation would be smoother and the costs—in terms of output and employment—would be less.

The Administration supports completely the stated policy of slowing the average rate of money growth and we believe that the announced target of 2.5–5.5 percent for 1982 is appropriate. However, in view of the severity of the current recession, we recommend monetary expansion in the upper one-third of the range. We hope that the actions by which this policy is implemented would produce a more even pattern of money growth, thus reducing the temporary, but very real, costs of the transition to less inflation.

CHART 1

MONEY AND GNP GROWTH

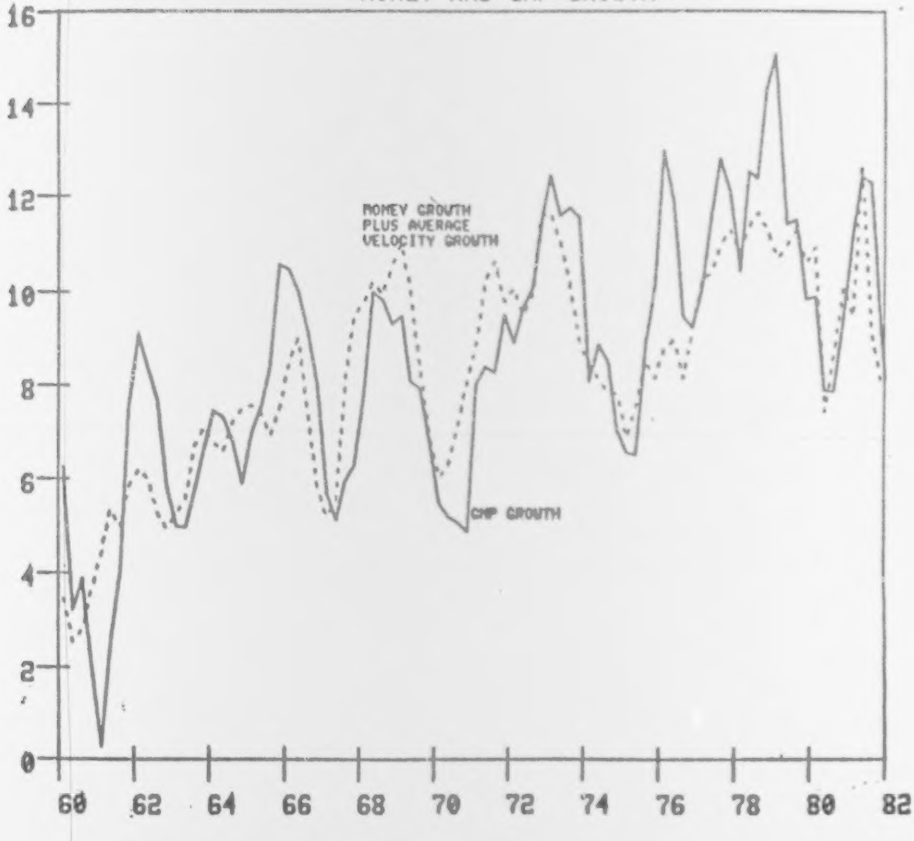
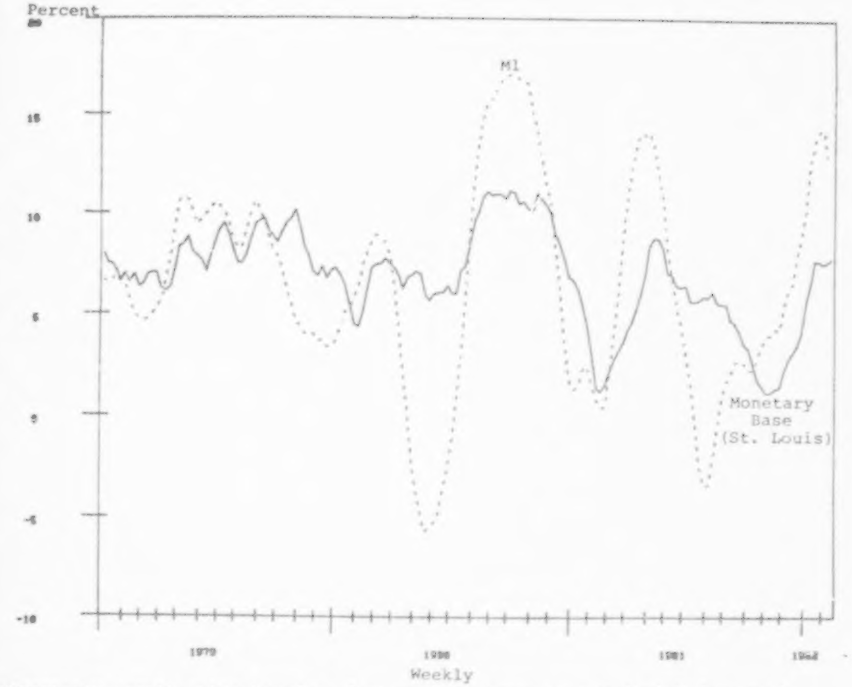


CHART 2




*Quarterly growth rates based on four-week averages compared with four-week averages thirteen weeks earlier, at annual rates. Latest week plotted Feb. 10 for M1 and Feb. 17 for monetary base.
Note: The M1 data series is being revised, but all historical data are not yet available. Therefore, 1981 and 1982 data are not strictly comparable to earlier years.

The CHAIRMAN. Thank you, Secretary Sprinkel.
Dr. Jordan.

## STATEMENT OF JERRY L. JORDAN, MEMBER, PRESIDENT'S COUNCIL OF ECONOMIC ADVISERS

Dr. JORDAN. Thank you very much, Mr. Chairman. It's a pleasure to appear before your committee once again. I will not read my statement, but rather summarize the main points in it.

The CHAIRMAN. Before you do that, I will caution you that a few weeks ago the Chairman of the Fed was here and he requested permission to summarize his statement, and when he finished I told him next time I would require him to read the entire statement because it took Chairman Volcker 1 hour and 10 minutes to summarize a 20-minute written presentation. So just be careful before you start.

I would also apologize for the lack of attendance this morning. First of all, Secretary Sprinkel should know the first reason. The Secretary of the Treasury is testifying before the Appropriations Committee this morning in their oversight hearings. We have, besides myself, several other members of the Banking Committee who are also members of the Appropriations Committee. So you're being upstaged by your boss downstairs and that accounts for a good number of our membership not being here. And then, if you were not aware, we were in session until nearly 2 o'clock this morning on the filibuster on the floor of the Senate. So I did want

you to know that none of you were being ignored deliberately and why many of the members of the committee are not here is principally because of the hearings in the Appropriations Committee.

Dr. Jordan.

Dr. JORDAN. Thank you. Just about 1 year ago when I met with this committee before joining the administration, the main point of my testimony was the fundamental issue of credibility of long-run monetary policy. I stressed that this, in turn, hinged on the credibility of fiscal policy. We would not be able to convince the financial market participants that we would be able to sustain in the long run a slow and noninflationary growth of the money supply if we did not make progress on controlling the rise of Government spending as a share of the national income. The markets understand that spending is the ultimate test of taxation, that all Government spending has to be financed by either current taxes, future taxes, or inflation; and they fear inflation, rightly, given our experience. Making progress on monetary control alone in the short run, even for a period of a year or so, while very important, is not sufficient. We must be making progress on the fiscal side to convince financial market participants that they can count on a noninflationary environment for the 10- and 20-year time horizons that they are operating in. I think today that uncertainty is still what is haunting the marketplace.

SLOW MONEY GROWTH

All of us want lower interest rates. We want them to come down for the right reasons, and to stay down, rather than just being artificially depressed. But more rapid growth of the money supply would not produce lower interest rates. It would produce higher interest rates. So all of the homebuilders, realtors, the business people, small businesses, and large businesses, the car dealers—that we have been hearing from and I suspect you and all of the Congress have been hearing from—who want lower interest rates should join us in supporting the Fed in trying to achieve a slow, steady growth of money, while the Congress works with the administration on trying to solve the fiscal problem. I think slower growth of money is as necessary a condition to get interest rates down as progress on the fiscal side.

If there was anybody that by last fall still believed that faster money growth would produce lower interest rates, the experience of the last 3 months should have finally convinced them that that simply isn't true. Interest rates were dropping sharply in the fall as we were moving into a recession. The money supply was quite slow compared to the year before and compared to the growth that had occurred in the spring of last year, but interest rates were dropping. It was a very welcome decline in interest rates, about 7 percentage points in the short-term interest rates, and we had hopes that it would continue into this year and provide a basis for a sustainable economic expansion.

But then we had an unanticipated and very rapid growth in the rate of the money supply—a 15-percent annual rate of increase—from October to January that is much higher than the Federal Reserve targets for this year. They didn't expect it, we didn't expect

it, and the markets didn't expect it. As interest rates rose, most of the decline of interest rates in the fall were erased by what happened.

Now in the past 2 weeks or so this acceleration in monetary growth has been halted. It's on the decline. There also has been a rally in the financial markets. I think if the monetary growth stays under control—the money supply returns to the Fed's announced target range and stays there—this will help to restore confidence in the market and interest rates will continue declining.

I think over the next several weeks, with monetary growth behaving better, interest rates will be in a general downward pattern even while the markets are watching Congress very closely to see whether the fiscal policy is brought into line with this downward trend in monetary supply.

A year ago the No. 1 problem clearly was inflation. We just had completed 1 year of 13-percent inflation. The people wanted it stopped. This morning the Bureau of Labor Statistics has reported that the Consumer Price Index rose in January three-tenths of 1 percent, less than a 4-percent annual rate. We've made good progress on inflation. We still expect for the full year that the Consumer Price Index will probably run something like in the 6- to 7-percent range. That will be down 2 or 3 percentage points, and other major inflation measures will be down 2 or 3 percentage points from last year and down several percentage points from the year before. That's good progress.

FINANCIAL MARKET PARTICIPANTS

We also had been expecting that slower rates of inflation would be accompanied by declining interest rates. For a while that was true, but financial market participants believe that all we're having is a cyclical decline in inflation. They worry that we may still have a secular rising trend, and when you're investing for 10 or 20 years you want to know what inflation is going to be over that whole period, not just for a year or two. So they are waiting before they come all the way down to what the recent inflation numbers would imply.

The experience with money growth and interest rates is quite clear over the last several years. In 1977 and 1978 we had a sharp acceleration in the growth of the money supply compared to what had been the case on average during the prior 2 years, and interest rates rose sharply. As a result, confidence was eroded regarding the longrun inflation outlook. In 1979 and 1980 we had several periods of sharp accelerations and decelerations of monetary growth and also highly volatile interest rates. As money growth would accelerate very sharply, confidence would erode about the longrun outlook and interest rates would rise. Then as money growth would lurch the other way and come down sharply, interest rates also would be coming down, and that pattern has continued into 1981 and now into early 1982.

In the early months of 1981 money growth slowed sharply compared to what had happened in the second half of 1980 after credit controls came off, and that was encouraging. Interest rates declined, and the administration projected that interest rates would

continue declining during all of 1981. We were optimistic. We were hopeful about declining interest rates, along with a much slower growth of money. Then in March and April, monetary growth suddenly accelerated very sharply, and interest rates promptly rose to very high levels. By midyear, monetary growth started coming back down rapidly, and interest rates also declined. That continued into the late fall, and then the last 3 months of unexpected, unwelcome monetary growth occurred and immediately interest rates rose sharply once again.

We are looking forward to a 4- to 5-percent growth in the narrow measure of money this year. With that we would expect nominal income growth of GNP to increase about 10 percent from the end of 1981 to the end of 1982. The GNP deflator measure of prices will rise about 7 percent, and real growth will be on the order of 3 percent. In the second half of 1982 we would have much higher real growth than that 3 percent for the full year, providing a basis for continued high growth of output and employment and declining inflation in 1983.

So if the Fed's announced target range for this year is sustained on average for the year in a fairly steady way, which we think is the proper monetary policy, and this is combined with a fiscal policy that is reducing Government spending as a share of GNP, we would start to reduce the Federal deficit and establish the basis for a sustainable economic expansion with lower inflation and lower interest rates.

Thank you, Mr. Chairman.

[Complete statement follows:]

Testimony

by

Dr. Jerry L. Jordan, Member
Council of Economic Advisers

Thank you Mr. Chairman and Members of the Committee. The main point I want to make in my opening remarks this morning is that it would be impossible to sustain a healthy growth of output and employment if a high rate of monetary growth were to occur this year. The experience of the last few years has demonstrated repeatedly that financial markets are highly sensitive to whether or not the Federal Reserve is achieving a growth rate of the money supply consistent with their announced target ranges. If there was anyone around last fall who still believed that faster growth of the money supply would produce lower interest rates, the experience of the last three months should convince them once and for all that that is wrong. Confusion about the relationship between money growth and interest rates arises to a large extent because of a common failure to distinguish between money and credit.

From October to January of this year the narrow measure of money (M1) expanded at a 15 percent annual rate and was accompanied by a very rapid increase of interest rates. If interest rates were to remain at the levels reached in January, or rise to even higher levels, it would not be possible to achieve a high rate of real growth. It would be naive to think that central bank operations to provide reserves at an even more liberal rate and promote even more rapid growth of money would have prevented this run-up in interest rates. On the contrary, more rapid growth of money, or a continued high rate

of increase of money, would produce even higher interest rates. The only way to achieve and maintain a lower level of interest rates that makes it possible to promote expansion of output and employment is to return the money supply to the originally announced target range and maintain it for the balance of this year.

The relationship between the growth rate of the money supply and movements of interest rates has been quite clear in recent years. In 1977 and 1978 growth of money accelerated sharply compared to what had been observed on average during the prior two years. As a consequence, interest rates rose sharply as credit demands increased and expectations of rising inflation intensified.

During 1979 and 1980 there were several periods of sharp accelerations and decelerations of monetary growth as well as highly volatile interest rates. Money growth declined sharply late in 1978 and during the first quarter of 1979, then reaccelerated sharply in the spring and summer when it appeared to many observers that the economy was starting to slip into recession. Rapid monetary growth once again increased fears of higher future inflation. The dollar promptly began to weaken on foreign exchange markets, gold prices shot up and the stock market weakened. Then in October 1979 Chairman Volcker announced that the Federal Reserve was

adopting new operating procedures designed to achieve lower and steadier growth of the money supply on average. However, several dramatic events created very considerable uncertainty in the financial markets. In November, Americans were taken hostage in the Embassy in Tehran, in December the Soviets invaded Afghanistan, and in January 1980 former President Carter announced a budget that indicated that very high rates of increase of government spending and taxation could be expected during the first half of the 1980s. Interest rates rose very sharply during the early months of 1980 until the Carter Administration pursuaded the Federal Reserve to invoke the powers of the 1969 Credit Control Act.

During the spring of that year, the money supply declined absolutely for the first time in many years as credit demands dropped sharply as a result of the credit controls and interest rates plummeted. Then in July of 1980 credit controls were removed, the economy began to rebound from the artificial constraints, credit demands increased, interest rates came under renewed upward pressure and the money supply accelerated to the highest rate of growth over a 6 month period that has ever been recorded. By the end of 1980, we were experiencing the highest levels of interest rates in recent history, and I doubt that many people believe that even more rapid growth of bank reserves and the money supply during that period would have prevented or slowed the rise in interest rates.

Late in 1980 and early in 1981, growth of the money supply slowed sharply and interest rates also declined. And declining short-term interest rates early last year occurred even though nominal GNP rose at a 19.2 percent annual rate, real output increased at an 8.6 percent rate and Treasury borrowing was the largest amount recorded for a single quarter until that point. But, unfortunately, there was a spike upwards in money growth in March and April in 1981 that unsettled the financial markets and was acompanied by renewed upward pressure on market interest rates. By mid-year money growth had returned to a slower and less inflationary rate and interest rates began declining once again. From their peaks in the summer until late fall, short-term interest rates declined about 7 percentage points. This was a very encouraging development and provided the basis for optimism that with inflation continuing to fall and interest rates declining further, the recession would be fairly short and recovery would get underway during the first half of 1982.

Unfortunately, however, another period of accelerated monetary growth occurred and both short- and long-term interest rates came under strong upward pressure in December and January. No one wanted interest rates to rise again during the past two months and no one wants them to remain at these levels. It is our strong belief that the way to achieve a near-term reduction in both short- and long-term interest rates is to return the growth of the money supply to a slow and steady rate.

Last week in his press conference, President Reagan indicated his confidence in the announced policies of the Federal Reserve and also stated that "We also support the Federal Reserve's 1982 money growth targets which are fully consistent with the Administration's economic projections for the coming year." I firmly believe that if money growth promptly is reduced to the announced target ranges, and a rate of increase in the 4 to 5 percent range is maintained on balance through the remainder of 1982, interest rates will decline, growth of output and employment will increase, while inflation will continue to decline.

The public perception of the relationship between money growth and interest rates is the reverse of what actually takes place because of the confusion between money and credit. Money is an asset that people generally accept as payment for goods and services. It consists of coins, currency, and checkable deposits. Credit, in contrast, is one party's claim against another party, which is to be settled by a future payment of money. Confusion about the difference betwen money and credit arises because people can increase their spending either by reducing their money balances or by obtaining credit.

The market for money is distinct from the market for credit. The supply of and demand for credit influence primarily the interest rate, which is the price of credit. The supply of and demand for money, on the other hand, determine the purchasing power of money. Additional confusion about the

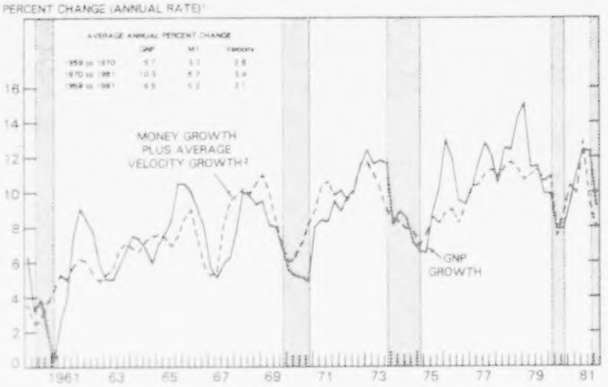
difference between money and credit arises because the monetary authorities create money primarily by purchasing credit market instruments. These actions tend to increase the supply of available bank credit and consequently tend to lower interest rates, at least initially. Over a longer period of time, however, the creation of money has important effects on economic activity that tend to raise interest rates. Monetary expansion leads to an expansion in nominal income and economic activity, which in turn generates an increased demand for credit, thus reversing the initial decline in interest rates. In addition, a sustained higher rate of monetary growth will soon produce higher nominal interest rates to compensate lenders for the expected decline in the real value of their wealth.

When interest rates are high, credit is often said to be "tight," meaning that it is expensive. This does not necessarily mean that money is tight in the sense that its quantity is restricted. Indeed, quite the opposite is likely to be the case. "Easy" money, in the sense of rapid growth in the stock of money, may very well be the underlying reason for a tight credit market. Conversely, tight money in the sense of slow growth in the stock of money is likely to lead eventually to a fall in nominal interest rates as inflation expectations subside. But it is credit, not money, that is easy. Over the long run, the effect of the growth of money on the real volume of credit is essentially neutral. Monetary expansion can succeed in driving up the nominal supply of credit as well as

other nominal magnitudes. But it cannot significantly alter the real supply of credit or the real interest rate (the nominal rate adjusted for inflation), except indirectly through the uncertainty associated with inflation and because of the effects of an unindexed tax system. Monetary expansion can permanently reduce the purchasing power of money, but not the real price of credit.

It is often stated that such financial innovation as money-market funds undermine the conduct of monetary policy. Statistical support for this assertion is dubious. What would have to be demonstrated is that financial innovation -- which is to a large extent the result of policy-imposed constraints on the financial system in an inflationary environment--has made it more difficult to achieve a given monetary target, and that the link between changes in nominal GNP and changes in the monetary aggregates -- that is, changes in velocity -- has become less predictable. The evidence does not seem to support either proposition. A study recently published by the Federal Reserve suggests that the monetary authorities have the ability to control the measure of transactions balances known as M1 with a reasonable degree of precision. Furthermore, changes in velocity do not appear to be any more volatile than they have in the past. Indeed, changes in the trend of the growth rate of nominal GNP over the period 1960 to 1981 are almost entirely attributable to changes in the trend of the growth rate of the money stock (M1), as opposed to changes in the trend of the growth rate of velocity (Chart).

## Money and GNP Growth




[1] PERCENT CHANGE IN 4-QUARTER MOVING AVERAGES OF SEASONALLY ADJUSTED MONEY STOCK (M1) AND GNP.

[2] AVERAGE VELOCITY GROWTH IS AVERAGE ANNUAL PERCENT CHANGE OVER THE PERIOD 1959 TO 1981.

NOTE.--SHADED AREAS INDICATE RECESSIONS AS DEFINED BY THE NATIONAL BUREAU OF ECONOMIC RESEARCH.

SOURCES: DEPARTMENT OF COMMERCE AND BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM.

In conclusion, this Administration has emphasized the importance of a long-run reduction of monetary growth to a steady, non-inflationary rate. The Federal Reserve has maintained its commitment to such a policy. Slower growth of money will mean less inflation and lower market interest rates.

In addition, as we have observed recently, short-run volatility of monetary growth, especially in an environment of considerable uncertainty about the ultimate fiscal actions of Congress, has been associated with highly volatile interest rates. Market uncertainty about long-run monetary and fiscal actions of the government has been reflected in an unusually large "risk premium" in interest rates. Steadier growth of the money supply, plus progress on achieving fiscal discipline, will result in lower interest rates and provide a foundation for sustainable growth of output and employment.

The CHAIRMAN. Thank you, Dr. Jordan.

WEEKLY REPORTING OF MONEY SUPPLY

Secretary Sprinkel, I asked Chairman Volcker this question a couple of weeks ago, and that was simply about the frequency of reporting the money supply. It has been my feeling that weekly reporting is ridiculous at best. I don't even believe the Fed can properly account or measure the money supply on a weekly basis, let alone manage it. I'm not one who believes as a monetarist that one-tenth of 1 percent here or there can be achieved. I think the economists are kidding themselves when they talk about that kind of fine tuning of the money supply.

He admitted that it was not accurate and that as long as they were collecting it they were forced to publish it, and I said, well, then, why collect it on a weekly basis; and he said, "Because someone else will call the banks and try to determine it and they will publish it." But that's unofficial. I don't think it would have the impact, at least in my opinion. But we send out false signals that affect the market and it does affect interest rates when the Chairman of the Federal Reserve Board admits they are highly inaccurate.

From your position in Treasury, what do you think? Do you think we ought to change that reporting frequency and collection and try to be more accurate so in this volatile situation we're not sending out false signals and false information?

Mr. SPRINKEL. Well, this issue is widely debated, as you are aware. There are good arguments on both sides.

The CHAIRMAN. I'd like to hear the arguments on the side of the weekly reporting.

Mr. SPRINKEL. I will give you mine in just a moment. I have been in this business a long time and I remember 20 years or so ago arguing that we should pay more attention to what happens to the money stock every quarter or every 6 months but nobody was interested. Now we have gone to the preposterous extreme of placing massive importance on what happens in any one week. That is just nonsense. I really don't care what happens in any one week, but the market cares.

STARTING A COTTAGE INDUSTRY

My fear is that if the Federal Reserve would cease to publish weekly money data a new cottage industry would start—George McKinney and his colleagues in New York and others in Chicago would immediately get in the business of estimating a weekly series. We would be right back where we are, except that valuable resources in the private sector would be used to do a nonsense job.

In my judgment, the solution is to focus on growth in the monetary base and then there would be little reason to pay so much attention to swings in the money supply in any one day or week. The base is controllable. There is just no doubt about that. The money supply in the short run is not precisely controllable and there is a lot of noise in it. So I am not strongly impressed with the argument that we should suppress weekly information or refuse to release information, but I think there are other ways of achieving the same

objective. But I confess there is an argument in favor of not publishing weekly money data. As far as I know, the United States is the only nation that does. We really should put the emphasis on the average rate of money during a quarter or 6 months. That is much more significant.

The CHAIRMAN. Mr. Sumichrast, you're not late, so don't worry. The second panel really hasn't done their thing yet. But inasmuch as you mentioned Mr. McKinney, I would like to divert away from your questioning at this point and ask him why are the markets concerned—if you would be concerned to start a cottage industry and try to estimate what the Fed had not done—why are you so interested in figures that everybody says are not accurate?

Mr. MCKINNEY. Because the Federal Reserve is paying attention to them and is pressured by Mr. Sprinkel, among others, to pay attention to money growth, and as long as we are paying attention to short-run money growth because others in authority are paying attention to it, we will have to watch what they are doing in order to stay alive. It would be a cottage industry. There would be a tremendous growth in computers. Beryl is entirely correct that every money market analyst with computers would have fair estimates of the money supply out. You know, I think the point is that as long as the Federal Reserve is trying to control money growth, they are not going to achieve steady money growth.

The Federal Reserve is only going to be successful in achieving steady money growth when it stops trying to control it, and markets will stop paying attention to short-term money growth only when the Federal Reserve stops paying attention to short-run money growth.

The CHAIRMAN. I know, but that really doesn't answer my question because Beryl said that he thought it was ridiculous and the reason he was doing it was because you wanted it, and you just said you wanted it because they wanted to give it out.

Mr. MCKINNEY. That's right.

The CHAIRMAN. Now which came first, the chicken or the egg here?

Mr. MCKINNEY. The targets came first. As long as the Federal Reserve is targeting money growth, as long as that's a known factor in their monetary policy, central to their policy, then we will try to keep as close an eye on it as they do in order to understand what it is that they are doing.

The CHAIRMAN. Again, that still isn't responsive to my question. If everybody admits—and I have yet to have anybody tell me anything else—that the weekly figures are not accurate, why are you all fighting over having some figures that are apparently meaningless? Everybody uses terms like "ridiculous." I don't know why we're doing it.

Mr. MCKINNEY. I do know why we're doing it. We're doing it because one of the important things for us is to determine what the Federal Reserve policy is in the short run.

The CHAIRMAN. In that short a run, in a 1-week period?

Mr. MCKINNEY. Sir, as long as we are told that the Federal Reserve should be holding money growth within a narrow band over short periods of time—short being defined as the swings that occurred during the last half of last year—then we will necessarily

have to pay attention to those things that make up the short-run swings in money growth.

BUSINESS DECISIONS

The CHAIRMAN. But are you making business decisions in your bank on the basis of admittedly inaccurate figures on a weekly basis?

Mr. McKINNEY. Of course we are, because that is the reality of life. If that is what determines what the Federal Reserve will be doing, then it is exceedingly important for us to know what the Federal Reserve will be doing; and if the Federal Reserve is following meaningless figures and if the administration wants the Federal Reserve to follow meaningless figures for short periods of time, then people who buy and sell securities have no choice but to try to figure out what they will be doing that will be influencing the price of those securities.

The CHAIRMAN. Maybe I'm terribly naive, but I really don't understand why this is controversial. I have never heard as much talk about fantastic amounts of money and people—Government and business making decisions on admittedly very poor information when we're talking about short run—to say they are targets for a quarter or semiannually or something and maybe 2 weeks might smooth that out a bit or a maximum of a month of reporting would give you more accurate figures on which to base your decisions. I guess it's because I'm not an economist and I don't understand this whole argument. It just baffles me and I can't imagine any little business saying I'm going to operate my business on some phony figures that come out every Friday.

Mr. McKINNEY. May I run in an analogy of the camel and the straw; that one more straw breaks the camel's back; and regardless of the validity of any particular straw—and that's a very poor analogy—you have to watch as the individual straws go on. Each week's figures makes some difference in the total. They may be right; they may be wrong; but that moving average that you're talking about—Beryl was talking about earlier—that moving average is influenced by each week's figures as they come out, and if, in my opinion, following an erroneous perception, the Federal Reserve does in fact try to target money growth on a slow average change, then I'm acting irrationally if I do not consider each one of the straws, each one of the weekly figures that contributes to that average change.

The CHAIRMAN. Except every time the Chairman of the Fed or a member of the Fed comes in here and they are being criticized for not hitting their targets, what they say is, "Don't worry about those blips. They are unimportant. They are meaningless."

Mr. McKINNEY. That's right.

The CHAIRMAN. "Look what we did over a period of a year." They talk in terms of 1 year or 6 months to explain all these phony ups and downs.

Mr. McKINNEY. Sir, I would agree most fully. I think it's entirely proper that the Federal Reserve should pay no attention to those blips and if it were possible to assume that the Fed were in fact not paying attention to those blips, if it were possible to assume that

pressure would not be placed on the Federal Reserve to follow those blips, then the market would logically be less concerned about those blips. But as long as we are told that the swing in money growth that happened last summer and the swing in money growth that happened in December and January are in fact important, as long as we are told that by the administration officials, then we know that the Federal Reserve will be subjected to the same kind of pressure. They will perhaps think along the same lines and we can do nothing——

The CHAIRMAN. Again, you're talking about last summer and last spring, not a particular week in last summer or last spring. Well, I'm taking their time. Dr. Jordan.

Dr. JORDAN. I agree that the weekly figures don't mean anything especially the seasonally adjusted figures. Statisticians simply can't defend them. But the market participants will always try and figure out what it is that the central bank is trying to control, and former Fed officials like myself will be paid by commercial banks, as I was, to second-guess them because you can make money—and you can also lose money if you guess wrong. In the last couple months millions of dollars were made and lost by dealers and traders based on some figures that a few years from now—after several revisions of the seasonal factors and benchmark adjustments—will have never happened. By 1985, there will not have been a 15-percent rate of money growth from October to January.

The point is that as long as the central bank itself seasonally adjusts the figures and internally uses them in any small way of adjusting their own operation, the market participants have an incentive to second-guess them. At one time it was free reserves. At another time it was simply the Federal funds rate. At still another time they used a concept called reserves available for private deposits. They said that was the target and the market participants tried to figure it out.

If the truth ever got out that the key to what monetary policy is actually is whether or not the Board of Governors has green peas for lunch on Thursday, you would have all of these people down there checking out the garbage cans of the Federal Reserve and watching the delivery trucks.

The CHAIRMAN. That may be as good a system as what we're doing now.

## WEEKLY MONETARY BASE

Dr. JORDAN. It's no different really because the weekly money numbers are a random number. So what I have been proposing—and I join Secretary Sprinkel on this—is that the weekly monetary base be used as an internal target for the Fed because that is their balance sheet and balance sheets have a habit of balancing. They can control their asset side and therefore they can control the liability side.

On the weekly monetary data, what I would suggest the Fed might consider doing is publish the raw components on a not seasonally adjusted basis, but publish the 4 weeks compared to the same 4 weeks a year earlier. A lot of European data are reported in this fashion. Each time they get a new week's figure demand de-

posits and all the various components would be published unadjusted, unmassaged. They don't have to worry about seasonality when they're reporting the percent change from the same period a year earlier. Let the cottage industry analyze those figures. Let all the investment banking houses and commercial bankers and Wall Street and Chicago and other places compete with each other to see who can do the best job of massaging or seasonally adjusting these figures.

But for that to work and not have the effect the weekly numbers have on the marketplace, the central bankers themselves would have to not react to it. They would have to focus either on total reserves or the monetary base in their own daily and weekly decisions.

The CHAIRMAN. If the monetary base is so good, why doesn't the Fed use it?

Dr. JORDAN. There's a continuing discussion about whether or not that's desirable. Economists have different opinions on that. The German central bank or the Swiss national bank have used their version of the monetary base for almost a decade now. The Federal Reserve Board of Governors only started publishing the monetary base, a version of it seasonally adjusted by them, about 2 years ago, whereas the Federal Reserve Bank in St. Louis has been publishing the monetary base for the United States since 1968. There have been differences of opinion in the profession as to what would be the implications of that, and it's an ongoing debate.

The CHAIRMAN. Why don't we go to contemporaneous reserve accounting too?

Dr. JORDAN. It would improve shortrun monetary control, assuming shortrun monetary control is desirable. Even if the improvement in control is very minor in a narrow statistical sense, or not important in terms of overall effects on the economy, such a move might serve as a signal to the marketplace of the serious intentions of the central bank to improve shortrun control, and that might have a salutary effect.

Mr. SPRINKEL. I believe that one reason we have not moved in that direction—it is not the only reason—is the very widespread opposition by George's industry and the commercial banking industry. They look upon it as involving an increase in high costs of operation and they are correct. I have talked to many bankers and there is no doubt that this would in the short run at least add to the cost of operation.

However, that is not an impossible obstacle to overcome. Clearly, if this were accompanied by some equitable reduction in reserve requirements, there need not be a net increase in costs, and yet we would tighten the monetary control mechanism. It has been my judgment, as I indicated in my testimony, that moving toward both contemporaneous reserve requirements and a much more flexible administration of the discount window would improve monetary control. I do not believe the Federal Reserve should be in the business of subsidizing borrowing banks and yet that is what happens when you have a low discount rate and high market rates of interest. Banks will always seek the cheapest money on the block and they will borrow from the Federal Reserve when they believe that it is profitable to do so. Every time they borrow from the Federal

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Reserve that adds to total reserves and complicates the process of monetary control.

The CHAIRMAN. Well, I guess we can get off this and we can beat it to death, but I'm still absolutely puzzled. Your testimony was that 20 years ago nobody cared about the money supply over a period of 6 months or a year. Now we're complaining about it on a weekly basis. Every witness admits it's a silly system and yet you're all going to stick with it. I'm sorry. I just don't understand why we continue operating on a system that everybody says doesn't work very well.

But be that as it may, Secretary Sprinkel, do you believe that the Fed's announced targets for money growth are adequate to finance a recovery if we get one this summer?

Mr. SPRINKEL. Yes, sir, I do. As you know, there is a widespread view that there is an inconsistency between supply-side measures taken by this administration and slower growth in money measures urged by this administration. That view of inconsistency is dead wrong. It results, in part, from looking at the world through what I would call Keynesian colored glasses, viewing tax cuts as stimulative to total spending. Of course, that has not been true historically nor would it be true in the future unless it is accompanied by a sharp increase in the money supply; that is, unless the deficit is financed by increasing money.

Our approach of supply-side action—that is, tax cuts, cutting Government spending as a percentage of GNP, and deregulation, is to tilt the decisionmaking process, not to increase total spending. We want to tilt decisions toward more emphasis on saving, investing, and working through increases in incentives. That is on the supply side—the capacity of the real economy to grow.

### EFFECTS OF STAGFLATION

But stagflation has two aspects. One is slow growth or no growth and the other is inflation. The evidence for this and every other nation that I have looked at—and I have looked at a lot of them—is that there is no alternative for bringing inflation down except by slowing growth in money. There is no inconsistency between monetary policy and the other aspects of our economic program. The proof will be in the pudding, and when this administration completes its first 4-year term, I can assure you that we will be known as a low interest rate, low inflation administration, but at the same time the economy will be performing much better than it has been.

The CHAIRMAN. I guarantee you, if that isn't the case, there will not be a second Reagan administration.

If the Fed is determined to target monetary aggregates, Mr. Sprinkel, which one should they use?

Mr. SPRINKEL. As I indicated in my testimony, my own preference is that they concentrate on the monetary base. The important thing is that they not concentrate on three or four different targets. It is impossible under any reasonable set of circumstances to hit three or four targets simultaneously, especially when you have institutional changes such as those which took place last year. These changes are not finished because we are proposing, with your aid, to move further along the deregulatory route. And conse-

quently, the "Ms" will probably continue to have a lot of noise in them.

The base can be controlled, since it is the balance sheet of the Federal Reserve Board and it would be my preference that it be the target.

The next choice would be $M_1$. Certainly we do not want four or five targets.

The CHAIRMAN. Dr. Jordan, as you're very well aware, Chairman Volcker as well as I and many others have been very critical of the budget deficits as well as the fact that credit markets—Government credit—the off-budget deficit is not really talked about. As large as the on-budget deficit is, it's much larger. Do you really think there's any way, regardless of what we do, that monetary policy can be effective until we start controlling those deficits?

Dr. JORDAN. No. I think in the long run, control of spending, including the off-budget credit program for the Government, is absolutely essential to a monetary policy. The financial markets understand that. The international markets understand that. And a lot of academic studies have been done, theoretical analyses and empirical work, to show if you're increasing interest-bearing Government debt, on-budget or off-budget, while trying to have a slow, noninflationary rate of money supply, what you do is raise real interest rates. Interest rates have to rise in order to equate credit demands and credit supplies.

In my testimony I mentioned this confusion between money and credit that causes people—the general public—to think that slow money growth causes high interest rates, and that's just not true. If the demand for credit goes up, then certainly the price of credit interest rates goes up, other things the same. But a slower growth of the money supply doesn't mean there's less credit available, and if the demands for credit by the Government sector continue to be as large as they have been in the past and as they are this year and that they appear they may be in the future, then it would be unrealistic to think that the price of credit—interest rates—would come down and stay down.

The CHAIRMAN. In your view, do you think the anticipated increases in savings and investment will occur under present economic conditions due to the tax reductions?

PERSONAL SAVINGS

Dr. JORDAN. The personal savings rate, I think, will continue to be quite a bit higher than it has been in the past, but that may be as much a result of monetary policy as tax cuts and fiscal policy in the short run. The main reason the savings rate dropped dramatically in the last several years was that the only form of real savings a lot of people had was increased equity in their home because of inflation. They would borrow against their house. They would refinance or take out a second mortgage or just generally carry more consumer credit than otherwise because of having a better balance sheet and that increased indebtedness by the consumers. It was a large part of what drove the savings rate down.

The reason the consumer went into debt was inflation and inflation fears—buy now before the inflation goes up and you deduct

the interest from your income taxes so you get a negative real interest rate on consumer credit. Now if the inflation outlook continues to improve, people are less willing to go into debt and also we're starting to have some marginal changes in the tax structure—the incentives about interest income versus interest expense. Then I think that consumer installment and mortgage credit will not be driven by inflation psychology.

So the personal saving rate will be higher. The lower marginal tax rates—the small cut we had in October and, the 10-percent cut we will have in July—raise the real cost of borrowing to the consumer because his tax deductibility of interest expense is not worth as much to him as it was before. That will also help raise the savings rate.

The CHAIRMAN. Would you advocate moving that July 1 tax cut up to January 1?

Dr. JORDAN. I think by the time anything was accomplished, was debated and enacted, it would have very little positive economic effect. I'm generally oppposed to what I would consider to be sort of fine-tuning type actions.

The CHAIRMAN. The reason I asked that is that I was rather surprised from the news magazines last week that former Vice President Fritz Mondale suggested that the third installment of the tax cut be removed, not the business cuts, the individual cuts, but this year's be made retroactive to January 1, which rather surprised me.

Dr. JORDAN. That's a view that the tax cut will stimulate consumer spending. It's the basic idea that you raise disposable income and the consumer will go out and spend that tax cut and stimulate the economy. That's what I consider to be an old-fashioned type of pump priming that I don't believe in. I think a private property, market oriented, economy is inherently resilient. It doesn't need that kind of shot in the arm to get it moving. It doesn't need us to artificially push down interest rates, to rapidly increase money, to bust the budget with new kinds of spending programs, and other things to get the economy expanding. I don't think it would work if we tried it. So I think it's best to leave the personal tax cuts alone. There's great virtue in having a multiyear personal tax cut that people can count on and plan on, and look to other aspects of the tax structure that need to be reformed and worked on.

The CHAIRMAN. Secretary Sprinkel, let me ask you one of the same questions I asked Dr. Jordan. You have been long involved in monetary policy. Do you think it can work unless we get the deficits under control?

Mr. SPRINKEL. I agree with everything Dr. Jordan said; that is, I think we need to operate on both the fiscal and monetary side to get the kind of real growth that all of us want in the period ahead.

Now that should not be interpreted as saying that we can make no progress on getting interest rates down until we balance the budget. Sometimes it gets interpreted that way. It is true that the higher the deficit, other things being the same, the higher the real rate of interest and such an increase is a deterrent to long-term capital formation. It is also true, however, that the most important components of current nominal interest rates are not the real rate of interest. That is relatively low, 3 or 4 percent and is related to

the marginal productivity of capital. The largest portion of those interest rates that exist today reflect both inflation expectations plus what I would term an uncertainty premium brought on by volatility in monetary growth. It is my judgment that continued progress in pulling inflation down, while achieving a more stable monetary growth pattern, would reduce nominal rates even though the deficit would tend to drive the real rate up. It is very important in the long run, even if we do not finance the current deficit with new money, to get the deficit down because if we use savings to finance Government spending those savings are not available to finance private capital formation. That is really the heart of our program. We must encourage private capital formation up and, in my opinion, that will not happen in a significant way with a 15 percent nominal rate of interest.

The CHAIRMAN. Mr. Secretary, when our factories are only operating at about 70 percent of capacity on the average, if a recovery should begin as predicted, would it be possible to tolerate $M_1$ growth above the targets without reigniting inflation?

Mr. SPRINKEL. No, I do not think so. The historic relation between money and inflation does not have to be adjusted for the degree of capacity utilization. In 1976, 1977, 1978, and 1979 there was a lot of excess capacity, and the argument was made, therefore, that we could afford to stimulate money growth; we could afford to have an expansive fiscal policy because we had all this excess capacity and stimulus would not cause inflation. Well, it did cause inflation.

We inherited that inflation and we certainly do not want to see the mistake repeated. We can not fine-tune and release the restraints on money growth, release the restraints on fiscal policy stimulus because we have a lot of excess capacity. Inflation would certainly increase.

The empirical work that has been done for most countries suggests that the lag is 1½ years or 2 years between a change in money growth and its full effect or inflation. More money inevitably causes more inflation, irrespective of the amount of excess capacity existing on the economy. So I would not want to see us fine-tune on the assumption that under present circumstances we can afford to follow a stimulative policy. That approach would only aggravate the mess that we were in and we are trying to get out of stagflation, not make it worse.

The CHAIRMAN. Dr. Jordan and Secretary Sprinkel, I appreciate you being here today. I have no more questions for you. There may be some from other members of the committee that may wish to have you respond in writing.

[Additional material received for the record follows:]

MR. MCKINNEY'S ANSWER TO SUBSEQUENT WRITTEN QUESTION OF SENATOR RIEGLE

*Question.* Mr. McKinney, did you say that it would be a good idea for the Federal Reserve to use selective credit controls to combat the inflation?

Answer: No, sir. I strongly oppose the use of selective credit controls. They have uniformly done more harm than good. They made the 1980 recession deeper and more severe than it would have been, and they added to inflationary pressures when we tried them in 1971.

What I meant to say is that it would be better for the Fed, instead of targeting money growth, to target growth of total credit. This is a much larger number than

money as such, and the relation between total credit and nominal GNP is much closer and more meaningful than that between money and nominal GNP. To shift to the broader target of total credit (or maybe some other broad target) would dissipate the present focus of attention on money growth. It would reduce the market reactions to blips in money growth, and it would let the Fed get on with the really important job it should be doing—influencing overall conditions in money and credit markets as a means of contributing to stable, noninflationary growth.

The CHAIRMAN. You are all welcome to stay here if you like; however, I understand your schedules and if you would like to depart you're welcome to do that as well. So I do thank you for coming.

Dr. JORDAN. Thank you, Mr. Chairman.

Mr. SPRINKEL. Thank you.

The CHAIRMAN. Mr. Schechter, would you like to proceed?

## STATEMENT OF HENRY SCHECHTER, DIRECTOR, OFFICE OF MONETARY POLICY, AFL-CIO

Mr. SCHECHTER. With your permission, I'd like to use a couple of more minutes, Mr. Chairman, to comment on some of the things I heard earlier this morning.

The CHAIRMAN. Yes, go ahead.

Mr. SCHECHTER. The emphasis on the relationship between inflation and money supply in my mind is unreal; the greater growth of inflation in the 1970's was due in no small respect to the great increase in energy prices resulting from the OPEC quadrupling of oil prices which had to be paid and it's spread throughout the entire economy. It was due to the fact that we had—not we so much, but Russia had drastic crop failures during the 1970's and the world prices of grains went up, including U.S. grain, and that had to be paid and caused inflation. It was due to the fact that we had a population growth composition, that is, we had a post-World War II baby boom coming into household formation age, and at the other end an increased longevity with people living longer, so we needed more housing units than we ever had, and there was a housing shortage and inflation in housing. Also, population factors caused increased demand for medical and hospital care and those were the major causes of inflation.

And to overlook that and say that money supply was everything, was a control over everything, is I think quite misleading.

[Complete statement of Mr. Schechter follows:]

### TESTIMONY OF HENRY B. SCHECHTER, DIRECTOR, OFFICE OF HOUSING AND MONETARY POLICY, AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS ON MONETARY POLICY

#### SUMMARY

Thank you for this opportunity to present the views of the AFL-CIO on monetary policy at this time.

The Federal Reserve has been pursuing its goal of restraining money and credit with the endorsement of the Reagan Administration. As repeated experience has shown, high interest rates stemming from tight money contribute to inflation, as higher interest rates are passed along to consumer purchasers and taxpayers. The various effects which lead to a painfully debilitated economy were well illustrated during 1981.

Home sales plummeted and total new housing units started during the year were at the lowest level in 35 years, less than 1.1 million. By January 1982, unemployment in the construction industry was 18.7 percent; and 946,000 construction workers were jobless.

High interest rates for consumer financing also depressed new car sales as new U.S. output for 1981 dropped to 6.2 million new passenger cars, down one-third from 1978. Hundreds of thousands of auto workers became unemployed. The many supplier industries for housing and automobile production also had to cut back.

As workers lost buying power, businesses had to carry larger than normal inventories for longer periods than had been anticipated, at interest rates ranging from 15 to over 20 percent, causing rapid increases in bankruptcies. The number of business failures increased by 44 percent in 1981; and in the first month of 1982, the number is up 43 percent over the same month in 1981.

At the same time, the higher interest rates increase the value of the dollar relative to foreign currencies. Prices for U.S. goods become less competitive in international trade. Further economic deterioration is developing as other industrialized countries raise interest rates to prevent outflows of funds, bringing on worldwide recession and reduced international markets.

As economic demand weakens further, supposedly interest rates should drop. It is doubtful, however, whether interest rates would decline to permit a significant reversal of economic trends. Businesses will try to restructure their short-term debt to long-term. A pent-up housing demand would surge forward as soon as a reasonable reduction in rates appears, and would soon again raise rates.

The federal government will also have to be borrowing more, because it has to meet high interest rates and because of the huge tax reductions enacted in 1981 to benefit primarily wealthy individuals and corporations.

By having an unemployment level 4 or 5 percentage points above a practical full employment level, the loss in national GNP, at an annual rate, is $300 to $400 billion. There is also a loss of hundreds of billions in income and tens of billions in savings and capital formation. The nation falls behind in providing an adequate housing stock to keep up with population growth and replacement of lost units, in modernization and expansion of its basic industrial plant and equipment, and in maintenance of an adequate public infrastructure. When an economic upturn occurs, the retarded economy suffers from an inflation-producing housing shortage and a national plant that functions at a lower productivity growth rate than competitors that have not relied upon the painful and debilitating tight money policy to fight inflation.

Thus, in the long run, the periodic use of tight money policy as the means of combatting inflation becomes counterproductive.

Personal interest income as a percentage of total personal income has been on the rise as the use of all types of credit expanded. Thus, between 1950 and 1960, the percent of personal income accounted for by personal interest income rose from 4.3 to 6.2. The percentage moved up more rapidly along with interest rates in the seventies, and in 1979 it was 10.8 percent. By 1980 the percentage of total personal income that was interest income rose to 11.9 percent and continued to accelerate in 1981, reaching 13 percent by the third quarter.

The higher income families have the purchasing power to bid away scarce resources from others by a capability to pay higher prices for end products and services. By early 1981, the relationship between the supplementation of high incomes by high interest rates and the purchase of higher priced products and services was becoming quite apparent.

The effects of repeating the pattern of tight-money/high interest rates, high unemployment and recession have been to help create a two-tier economy with an upper tier that can indirectly or directly pay for high interest rates and support productive capacity for luxury type goods and services. However, basic industries, such as steel, glass, aluminum, and lumber, which must supply mass market products such as housing and automobiles, cannot be sustained or modernized because they cannot pay competitively high interest rates.

We should turn away from the disastrous reliance on tight money as the sole policy to fight inflation. Because tight money results in rationing through high interest rates, thereby often favoring unproductive uses of credit such as corporate takeovers, excessive commodity speculation, speculation in international exchange, and expanding capacity for production of luxury goods and services, the President should authorize the "Fed" to use selective credit controls to channel credit for productive purposes.

There has been a growing number of authoritative voices that have indicated the need to control the growth of credit.

Experience both here and abroad demonstrates the credit controls provide a viable alternative to slowing down the money supply. The brief implementation of controls in 1980 proved helpful in rapidly bringing down interest rates. As a result, the decline in home building and general economic activity was reversed. Japan has

used credit regulation in recent years to help keep inflation and unemployment at levels well below those of the United States and has also guided capital flows into high priority industrial investments. Japan has had lower interest rates, lower inflation, lower unemployment, and greater industrial production growth than most countries. On the other hand, the United Kingdom which has been following a monetarist policy similar to that of the United States, has a very poor economic record.

If selective credit regulations are used to defer capital investment that is not urgent and bring interest rates down to affordable housing levels, depository institutions specialized in home financing could remain in business, a needed higher level of residential cons ,uction could again be achieved, and the economy as a whole would be in a healthier condition.

The Credit Control Act of 1969 provides the authority to use flexible credit controls as a supplement to general monetary policy. The AFL-CIO strongly supports making this authority permanent before its scheduled expiration in June 1982 and using it now to bring down interest rates and revive housing and key sectors of the economy.

Thank you for this opportunity to present the views of the AFL-CIO on monetary policy at this time.

The Federal Reserve has been pursuing its goal of restraining money and credit with the endorsement of the Reagan Administration. High interest rates have reduced purchasing power and caused steep increases in unemployment and record numbers of business failures. These consequences, along with the gutting of programs which help maintain purchasing power during an economic downturn, threaten to push the economy into a deep, prolonged depression.

Tight money policies do not deal with causes of inflation, such as OPEC-dictated oil price increases, shortage-induced inflationary house price increases, runaway medical costs, and food price increases related to poor crop years. As repeated experience has shown, high interest rates stemming from tight money contribute to inflation, as higher interest rates are passed along to consumer-purchasers and taxpayers. The various effects which lead to a painfully debilitated economy were well illustrated during 1981.

Throughout 1981, interest rates remained at a relatively high rate. The prime business loan rate, for example, fluctuated between 15.75 and 21.5 percent. Conventional home mortgage rates which generally move more slowly, rose from 14.8 percent in January 1981 to above 17 percent in January 1982. As a result, home sales plummeted and total new housing units started during the year were at the lowest level in 35 years, less than 1.1 million.

By January 1982, unemployment in the construction industry was 18.7 percent; and 946,000 construction workers were jobless.

High interest rates for consumer financing also depressed new car sales as new U.S. output for 1981 dropped to 6.2 million new passenger cars, down, one-third from 1978. Hundreds of thousands of auto workers became unemployed. The supplier industries for housing and automobile production had to cut back and lumber mills, steel mills, copper mills, and other production and distribution activities had to lay off workers.

As workers lost buying power, businesses had to carry larger than normal inventories for longer periods that had been anticipated. The burden of financing such inventories at interest rates ranging from 15 to over 20 percent caused rapid increases in bankruptcies. The number of business failures increased 44 percent in 1981; and in the first month of 1982, the number is up 43 percent over the same month in 1981.

At the same time, the higher interest rates increase the value of the dollar relative to foreign currencies. Thus, in the third quarter of 1981, the exchange rate index of the U.S. dollar against the average for currencies of 14 industrial countries was up 16 percent over a year ago. As a result, prices for U.S. goods become less competitive in international trade. Further economic deterioration is developing as other industrialized countries raise interest rates to prevent outflows of funds, bringing on worldwide recession and reduced international markets. During 1981, U.S. merchandise imports exceeded exports by $40 billion.

The recession thus gathered momentum. As the economy weakened, interest rates declined, but only briefly. In fact, the decline in short-term rates starting in October was hailed as a beginning of a downturn in interest rates. However, the downturn was reversed in November, and both short-term and long-term rates rose significantly until last week.

Despite the one-month reduction in the unemployment rate to 8.5 percent in January, there is a strong concensus, based on various economic indicators, that unemployment levels will rise in future months. As economic demand weakens further,

supposedly interest rates should drop and the economy should enter a recovery phase. It is doubtful, however, whether interest rates would decline to permit a significant reversal of economic trends. Businesses have been doing their debt financing in large measure on a short-term basis and will try to restructure their debt to long-term when interest rates begin to decline. A pent-up housing demand, related to the age composition of the population, that is now restrained by high interest rates, would surge forward as soon as a reasonable reduction in rates appears, and would soon again raise rates.

The federal government will also have to be borrowing more, because it has to meet high interest rates and because of the huge tax reductions enacted in 1981 to benefit primarily wealthy individuals and corporations. Between September 1980 and September 1981, the average interest rate on the outstanding interest-bearing public debt of the U.S. Treasury rose from 9 percent to 11.5 percent. The annual interest charge in dollar terms rose from about $80 billion lo $112 billion or about 40 percent, although the debt itself rose only about 10 percent.

Given that outlook for pressures on the long-term capital market, it is unlikely that there will be any marked reduction in long-term interest rates that would stimulate a high level of housing market demand. Business investment also is unlikely to pick up if long-term bond rates don't go below a range of about 15 percent and the manufacturing capacity utilization rate is at about the current 70 percent level.

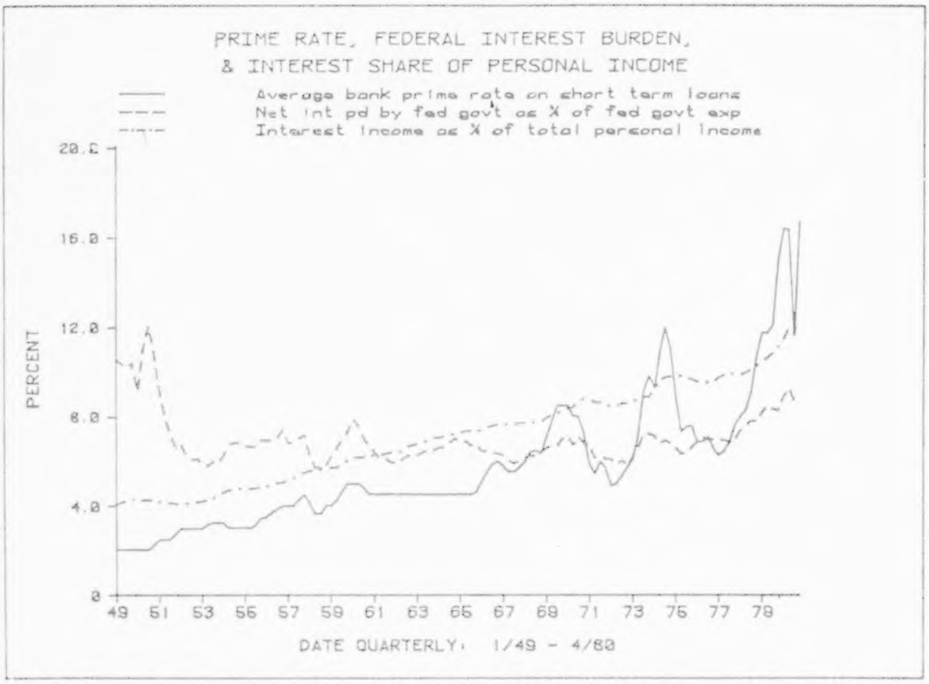
The likelihood is that unemployment will reach a level between 9 and 10 percent during 1982. If a short-lived recovery should then ensue and be rising by high interest rates, as seems likely, unemployment would tend to remain at an above 8 percent level. Every one percent of unemployment leads to about a 2½ percentage point reduction in GNP, or a loss of roughly $75 billion. By having an unemployment level 4 or 5 percentage points above a practically full employment level, the loss in national GNP, at an annual rate, is $300 to $400 billion. There is also a loss of hundreds of billions in income and tens of billions in savings and capital formation. The nation falls behind in providing an adequate housing stock to keep up with population growth and replacement of lost units, in modernization and expansion of its basic industrial plant and equipment, and in maintenance of an adequate public infrastructure. When an economic upturn occurs, the retarded economy suffers from an inflation-producing housing shortage and a national plant that functions at a lower productivity growth rate than competitors that have not relied upon the painful and debilitating tight money policy to fight inflation.

Thus, in the long run, the periodic use of tight money policy as the means of combatting inflation becomes counterproductive.

The frequent, prolonged periods of high interest rates have also altered the distribution of income in the country in a way which tends to support inflationary private demands that are less affected by high interest rates than other demands. A movement toward greater inequality of income distribution since 1967 followed the upward trend of interest rates and of the increasing share of personal income payments accounted for by interest income. As can be seen on Chart 1, during the fifties, interest rates remained at relatively low levels. It was not until the mid sixties that they began to move up sharply and, despite some cyclical downturns during recessions, had an upward tilt through the seventies and into the eighties.

Throughout the post-World War II period, personal interest income as a percentage of total personal income was on the rise as the use of all types of credit expanded. Thus, between 1950 and 1960, the percent of personal income accounted for by personal interest income rose from 4.3 to 6.2. The percentage moved up more rapidly along with interest rates in the seventies. By 1970 it had reached 8.6 percent, and in 1979 it was 10.8 percent. Then the upward movement of that percentage accelerated in the last two years as interest rates reached record high levels. By 1980 the percentage of total personal income that was interest income rose to 11.9 percent and continued to accelerate in 1981, reaching 13 percent by the third quarter.

Chart 2 shows the rising proportion of total personal income accounted for by interest income over the past three decades, following the long-term upward trend of interest rates. It also shows the acceleration in recent years of the interest income-to-total income ratio and of federal interest payments as a percent of total budget expenditures.




High-income families with substantial discretionary income have more savings and other financial assets than others, as has been shown consistently in periodic surveys of consumer finances conducted over three decades by the University of Michigan Survey Research Center. The accelerating proportion of total personal income accounted for by interest income was bound to be reflected in the income distribution. In 1979, the families in the top 20 percent of the income distribution had incomes above $31,600 and the top 5 percent above $50,300. In 1980, the comparable benchmarks of $34,500 and $54,000 were above a year ago by 9.2 percent and 7.6 percent, respectively, while the median income rose only 7.3 percent.

Detailed data available for 1979 also show a correlation between the share of the total amount of education and the share of aggregate income received by each quintile in the family income distribution.

| | Percent of aggregate family income | Percent of total school years completed by family earners |
|---|---|---|
| Lowest fifth | 5.3 | 8.5 |
| Second fifth | 11.6 | 15.0 |
| Middle fifth | 17.5 | 20.5 |
| Fourth fifth | 24.1 | 24.6 |
| Highest fifth | 41.6 | 31.4 |

Thus, the higher income families had a greater educational background, which lent itself to self-interest deployment of funds to obtain the highest yields. This they did, as shown by the strong upward trend in direct investments in securities plus money market fund shares. They would also have the purchasing power to bid away scarce resources from others by a capability to pay higher prices for end products and services.

They were also increasing consumer expenditures in a pattern to cause and enable certain product and service sectors to expand their capacity. The evidence with regard to the types of consumer expenditures made by the high income fami-

lies is more fragmented than the data on household investments. However, by early 1981, the relationship between the supplementation of high incomes by high interest rates and the purchase of higher priced products and services was becoming quite apparent, as reflected in the following excerpt from an article in Business Week of March 9, 1981.

Although high interest rates have increased the costs of consumer borrowing, they have also become an increasingly important source of income to growing numbers of consumers who put money in high-yielding money market funds or cash management accounts. Interest income as a percentage of total personal income increased by more than one-third from 1973 to 1980, going from 8.8 percent to 11.9 percent.

The two-tier consumer market is "almost the sole reason consumer spending has outpaced forecasters' estimates," says Albert G. Matamoros, vice-president and chief economist of Armstrong World Industries Inc. The weight of the top tier of the market in determining the strength of overall consumer spending is staggering. According to economist Carol Brock Kenney of Shearson Loeb Rhoades Inc., the richest 40 percent of all households account for 60 percent of all retail sales and two-thirds of all spending on such highly discretionary durables as automobiles and color TVs.

Data from a 1980 survey of markets of affluence indicated demands for other types of discretionary expenditures that were also largely supported by high income households. For the survey (by Monroe Mendelsohn Research, Inc.) adults in households with incomes of $40,000 or more were denied as affluent. It found, first, that affluent households accounted for 70 percent of household securities. Some examples of the types of consumer expenditures found to be dominated by affluent households included the following.

The affluent are eighteen times more likely to travel on a domestic airline than the nonaffluent; more than one-third of the affluent take seven or more round trips a year.

The affluent spend four times as much for jewelry and watches as the nonaffluent.

Better than nine out of ten affluent adults stay at a foreign hotel or motel during a year.

Historical data on total annual personal consumption expenditures and on selected "discretionary income" components for luxury goods and services are shown in Table 1 for the years 1947 through 1980. The five selected categories of expenditure are for (1) recreation including toys, sports equipment, bikes, boats, and pleasure aircraft; (2) "other recreation" including bowling alleys, riding, skiing, and swimming places; amusement parks, golf courses and sightseeing buses; (3) foreign travel and expenditures overseas; (4) airline travel; and (5) jewelry and watch expenditures. The proportion of total personal consumption expenditures accounted for by these five categories in some benchmark years were:

2.5 percent in 1947.
2.9 percent in 1960.
3.3 percent in 1965.
3.7 percent in 1970.
4.0 percent in 1975.
4.1 percent in 1976.
4.2 percent in 1977.
4.0 percent in 1978.
3.9 percent in 1979.
4.1 percent in 1980.
4.0 percent in 1981.

The dollar amount of these expenditures in 1981 was $74 billion.

The effects of repeating the pattern of tight-money/high interest rates, high unemployment and recession have been to help create a two-tier economy with an upper tier that can indirectly or directly pay for high interest rates and support productive capacity for luxury type goods and services. However, basic industries, such as steel, glass, aluminum, and lumber, which must supply mass market products such as housing and automobiles, cannot be sustained or modernized because they cannot pay competitively high interest rates.

The volatility that is created in the economy, and particularly in financial markets, also encourages credit-supported industry acquisitions, instead of modernizing and expanding basic industries.

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THE NEED TO SUPPLEMENT TIGHT MONETARY POLICY

In addition to auto production and home building, capital formation, employment, and the entire economy have suffered as a result of the tight money policy which is supposed to combat inflation.

The solution to the problem of economic instability and retardation must be sought in a more effective means of fighting inflation. The record of recent decades shows that reliance upon the Federal Reserve's policy of tightening up the money supply to control inflation is ineffective.

It is ineffective because the resultant high interest rates add to inflation both directly and indirectly. The cost of goods and services that must be financed rises as interest expenses are directly rolled into prices. The skyrocketing cost of purchasing a home is perhaps the most striking example of this process. Because high interest rates discourage demand, the manufacturing capacity utilization rate declines, and businesses can't operate at levels of peak efficiency. This increases the cost of production. In addition, low capacity utilization rates, in combination with high interest rates, discourage investment. This retards productivity growth, adding to cost pressures.

A longer run effect results from the increased unemployment of men and machines. Hundreds of billions of dollars of national product and income are foregone. Tens of billions of dollars of savings and capital formation are also lost. The economy is left with less adequate stocks of housing and industrial equipment than could have been produced and is more susceptible to the next round of inflation.

We should turn away from the disastrous reliance on tight money as the sole policy to fight inflation. Because tight money results in rationing through high interest rates, thereby often favoring unproductive uses of credit such as corporate takeovers, excessive commodity speculation, speculation in international exchange, and expanding capacity for production of luxury goods and services, the President should authorize the "Fed" to use selective credit controls to channel credit for productive purposes. Examples of these include: home mortgages; new residential, industrial, and commercial construction; farming; financing of capital equipment, cars, and trucks; and industrial and state/local government bonds for necessary public capital. By making credit less accessible for nonproductive uses, interest rates for productive uses would tend to decline.

There has been a growing number of authoritative voices that have indicated the need to control the growth of credit including Henry Kaufman of Salomon Brothers and Professor Benjamin Friedman of Harvard. Albert Wojnilower of First Boston Corporation has written at length about the need to have some forms of credit controls.

Experience both here and abroad demonstrates that credit controls provide a viable alternative to slowing down the money supply. The brief implementation of controls in 1980 proved helpful in rapidly bringing down interest rates. As a result, the decline in home building and general economic activity was reversed. Japan has used credit regulation in recent years to help keep inflation and unemployment at levels well below those of the United States and has also guided capital flows into high priority industrial investments. It regularly has restrictions upon total credit growth and also guides capital fun flows into long-range development of basic industrial capacity in selected industrial sectors. Japan has had lower interest rates, lower inflation, lower unemployment, and greater industrial production growth than most countries. On the other hand, the United Kingdom which has been following a monetarism policy similar to that of the United States, has a very poor economic record. Comparison of a few most recent key economic indicators for the three countries is noteworthy:

| | Percent change over 1 year | | Unemployment rate (percent) | Interest rates (percent)[1] |
|---|---|---|---|---|
| | Industrial production | Consumer prices | | |
| Japan | +5 | +4.5 | 2.2 | 6.6 |
| United States | -8 | +9 | 8.5 | 14.6 |
| United Kingdom | -1 | +12 | 12.7 | 15.9 |

[1] 3-month Eurocurrency rate as of Feb. 8, 1982.

If selective credit regulations are used to defer capital investment that is not urgent and bring interest rates down to affordable housing levels, depository institu-

tions specialized in home financing could remain in business, a needed higher level of residential construction could again be achieved, and the economy as a whole would be in a healthier condition.

The Credit Control Act of 1969 provides the authority to use flexible credit controls as a supplement to general monetary policy. The AFL-CIO strongly supports making this authority permanent before its scheduled expiration in June 1982 and using it now to bring down interest rates and revive housing and key sectors of the economy.

The CHAIRMAN. On that point I guess I would disagree with both of you. I think you're right about them blaming it all on monetary policy, but looking back at that, you're correct. I disagree only to the extent that the component of OPEC and so on and housing increases were about 4 percent of the 13- or 14-percent inflation during those years. So I think you're both overestimating inflationary causes for your point of view, and I still feel the prime fault lies right here with Congress—neither monetary policy or OPEC.

It's Congress and that trillion dollar debt, and I'd like to get back more into that with you.

Mr. Sumichrast.

## STATEMENT OF MICHAEL SUMICHRAST, CHIEF ECONOMIST, NATIONAL ASSOCIATION OF HOME BUILDERS

Mr. SUMICHRAST. Mr. Chairman, I would like to sum up my testimony in order to save time. I don't want to really get into the conceptual argument. I will leave it to other people to discuss that.

I'd like to simply state that the result of monetary and fiscal policies is obviously very high interest rates.

The CHAIRMAN. We will put your detailed statement in the record.

Mr. SUMICHRAST. Interest rates kill housing. It's that simple. From the very practical point of view, this is where we are. We simply cannot build houses with the prime at 20, 21, and 22 percent. We cannot. There's no way in the world you can do that and you cannot sell them when the auction price is at 18.2 or 18.3 percent. You cannot sell houses.

As a result, we cannot function in a climate of interest rates as volatile as we have seen since 1979. We have had an increase and decline in a short period of time such as we have never seen. There must be something fundamentally wrong with policies that create that sort of upheaval.

Now we have an industry which functions in a planning stage of not months but years. How can you ask anybody to make any kind of a plan for 1983 and 1984 in order to get any project underway when you cannot even guess what the rates are going to be tomorrow? We live under the pressure of what changed Friday at 3 o'clock that wasn't there at 2:30 before the money supply was announced. It's totally ridiculous.

### LONGEST HOUSING RECESSION ON RECORD

I think, as a result, we are facing a major decline. We have had the longest recession in housing on record. We have had 6 months of activity below 1 million units, something we have not seen since 1945. We ended up 1981 with the lowest production level since 1946 and we had 19 million less people in 1946. We cannot sell houses.

We have about half a million new unsold houses, about 5 million houses sitting there with a "For Sale" sign and we can not move them. It's just totally devastating to our industry.

Henry mentioned that we have a very high unemployment rate. We have 946,000 construction workers out of work, but that doesn't really take into consideration about 40 million more single individuals who are out of work.

What I would suggest we need—and we need very fast—is some decline in interest rates because, as I said, we cannot function in a climate where the interest rates are going the wrong direction. Right now the prime is at 16.5, but it's way too high. You asked me what I suggest we do on the side of monetary policy. I have a couple of ideas.

Last summer I wrote a short analysis of the Fed's policy and my suggestions. I still think they are pretty valid and I included them in my testimony. What I would really urge you to do is have some discussion about the wide range of targets. I looked at some of the other countries—Henry was in Japan and we examined some other countries in Europe and looked at their monetary policy and how they function. I think there's a very great need to really say what the targets should be and whether they should be tied to growth.

Second, I'm not so sure that the monetary policy itself works. I don't even know if it can work in this kind of framework. There was a discussion about the money growth. Well, watching the Federal funds rate probably is a better way than watching the money supply.

I think also we should take a look at the makeup of the Fed. Some other countries have an entirely different makeup of the Fed than we have. I know when I talked with Chairman Miller when I was being considered for Board membership a couple years ago he told me that one of the problems we have is that we're supposed to control the commercial banks through the monetary policies and yet we don't have a banker on the Board. I think it's one of the weaknesses of the whole setup. Some countries have a different sort of an attitude toward setting up the board.

### ADMINISTRATION VERSUS FED

Probably the most disturbing thing from where I sit is the bloody fight between the administration and the Fed itself. I just heard Mr. Sprinkel say they're all in one corner; they're not fighting; but really it's a bloody fight. It's a conceptual fight. It's a political fight, and I think we're right in the middle of it and the country is not gaining anything by that.

I think one of your functions is to try to be an arbitrator between these two bodies.

The CHAIRMAN. I have been trying to do that on my legislation between the banks, savings and loans, the realtors, homebuilders and the securities industry. That's why I'm so bruised and beaten. I don't think being an arbitrator works too well.

Mr. SUMICHRAST. I would suggest that the targets which they suggest are probably too low. I made some suggestions. I don't really know what the targets should be. I have no idea. I don't think the Fed does. I don't think they even know what money is.

I'm certain now that nobody can really define money. As my friends in Wall Street tell me, is it a state of mind; is it my potential credit that I can get as a businessman; or is it something else? And I think everybody probably would agree with me—maybe not on many things—but in the whole spectrum of the thing I think the movement toward the targeted money growth did more damage, at least for our industry and also the small business.

That's about all, Mr. Chairman.

[Complete statement of Mr. Sumichrast follows:]

STATEMENT OF THE NATIONAL ASSOCIATION OF HOME BUILDERS

Mr. Chairman and Members of the Committee: My name is Michael Sumichrast and I am Chief Economist and Staff Vice President of the National Association of Home Builders. I am testifying today on behalf of the more than 116,000 members of the National Association of Home Builders (NAHB). NAHB is the trade association of the nation's home building industry. I am here at your invitation to testify on the conduct of monetary policy during the latter half of 1981 and on what the monetary policy strategy should be during 1982.

Mr. Chairman, I appreciate the opportunity to appear here today.

I have prepared a detailed situation report concerning the housing industry which I would like to include in the record. I did this simply to bring to your attention the impact of monetary as well as fiscal policies on the housing industry. In short, they have almost devastated housing.

The expansionary fiscal policies, with record deficit financing and very high monetary policies, resulted in record high interest rates. Never before has the housing industry faced a run up of interest rates of such magnitude.

These policies resulted in the decimation of housing—with the longest post war recession, the lowest production year, drastically reduced sales and unparalleled bankruptcies.

The critical point of my presentation is the need to reduce all interest rates.

If they do not decline, we cannot survive. Neither can many others. I voiced my concern to Chairman Volcker and told him that I can not imagine a scenario with a run up in interest rates such as that suggested by Henry Kaufman. Not that Kaufman is wrong, he is looking at the current budgetary situation. But, because it is inconceivable that we might have a re-run of the 1930s with massive defaults in the thrift industry as well as bankruptcies of scores of major manufacturing companies, not to mention thousands more construction companies.

HOUSING SITUATION

Our industry just experienced one of its most difficult years.

In 1981 we built only 1.1 million new housing units, the lowest level since 1946. In 1946 the United States had a population of 141.9 million—that's 86.9 million less people than we have in the U.S. today.

Even in 1946 our rate of housing starts was 7.21 per 1,000 population—compared to 4.79 last year. This, by the way, was the lowest rate since 1945, when we only started 326,000 new units.

Our current level of production is 56 percent below the 1977-78 period.

January was the sixth straight month in which the seasonally adjusted annual rate of starts was below one million. That has not happened in housing since 1945.

This is a single family housing recession: for the one million units we are not building, 78 percent are in single family homes.

Single family sales in 1981 were the lowest on record—426,000 units.

1981 was the lowest year in the resale market since 1974.

Existing sales in December 1981 were down 33 percent from one year ago, and down 52 percent from the November 1978 peak of 4,060,000.

Delinquency rates for 1-4 unit residential loans are up 6.4 percent from third quarter 1980 to third quarter 1981.

The construction failure rates through August 1981 are up 41 percent over 1980.

Unemployment in the construction industry in 1981 (15.6 percent) was much greater than in 1980 (14.1 percent) and 1979 (10.3 percent).

946,000 wage and salary workers were out of work in January 1982 compared to 712,000 last year.

Construction unemployment in January 1982 (18.7 percent) was significantly higher than the depressed market of one year ago (13.7 percent).

The January unemployment figure is the highest since August 1975 (19.1 percent).

The thrift institutions recorded record net outflows of $39.3 billion in 1981, compared to inflows of $5.8 billion in 1980 and $8.1 billion in 1979.

New commitments made by savings and loans in 1981 ($55.9 billion) were down 28 percent from 1980 and 45 percent below 1979.

HOUSING PROSPECTS

1982 will not be a good year for housing. There is, however, some hope that some improvement will occur in the latter part of the year.

Why do I think we will do marginally better in 1982 and better still in 1983? Because I am convinced that all interest rates will decline. And, if I am right—and I hope and pray that I am—we will start selling more homes than we are selling today.

It won't be too difficult to sell more. The level of sales could hardly go any lower, in spite of all kinds of help which builders are currently providing to reduce their inventory.

I am suggesting a marginal recovery at best this year because we will miss most of the first part of the year—instead of selling we will be sitting and watching interest rates which are still very high. For a while last fall it looked like we might take good news to our annual convention in Las Vegas in January and tell our builder members that the FHA rate was 14 percent. Instead, the FHA rate was increased by one hundred basis points from 15.5 to 16.5 percent, and the increase just happened to coincide with Secretary Pierce's arrival in Las Vegas to speak to our Board of Directors. That's rather like being hit over the head with your own size 13 shoe.

The Administration blames the FED for high interest rates. The FED blames the Administration, saying that expected deficits congest the financial markets and keep all interest rates high. We, unfortunately, are caught in the middle.

We are in the midst of one of the deepest post war recessions. Interest rates should be declining, not increasing. Historically, they always did, as demand for private credit decreased. But not now.

Also, the drop in the inflation rate should have lowered all interest rates. First, it did. Now, even though we have more evidence than ever of declining inflation, rates are still climbing.

Why?

No one knows for sure. Last fall all indicators pointed to a deepening recession and all interest rates started to come down. Then the money supply started to increase. Not even the FED is sure why. Some claim that the economy started to revive a bit, but that contention proved to be false. On the contrary. After an anemic growth rate of 1.5 percent (annual rate) in the Gross National Product in the third quarter of 1981, GNP dropped like a lead balloon in the fourth quarter by 4.7 percent. The unemployment rate jumped to nearly 9 percent with a new record number of people out of work: 9.5 million.

The economy continued to weaken in January. Industrial production declined sharply by 3 percent, capacity utilization dropped further to its lowest level in seven years and housing, as well as automobiles, continued to decline.

Again the FED blamed the Administration. Deficits are too high and prospects for deficits down the pike are messing up the financial markets. And the Administration kept repeating that the FED policies should be somewhat more accommodating. The Administration now realizes that unless we have a turnaround in interest rates, the proposed turnaround (on which all of the economic assumptions are based) will not happen.

Most people, in and out of government, agree on that score, including the President, who said: "High interest rates present the greatest single threat today to healthy, lasting recovery."

THE NEED FOR HIGHER MONEY GROWTH RATE

Those who criticize the FED have a point. The present targets for money growth do not give enough room for the economy to grow to the levels suggested by the President. When the recovery begins, we will certainly bump against the monetary growth rates set by the FED. These growth rates are arbitrary and considerably lower in order to accommodate such projected growth. The result will be another round of rising interest rates. Why? Because demand for credit will increase, but will be cut off because the rates will go up again.

Clearly, the FED is in the driver's seat. Their tight money policies are working very effectively to curb demand. This is done at the expense of unparalleled suffer-

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ing in the labor force, and by business—both large and small. If continued, it will absolutely curb any growth by allowing interest rates to remain high.

And if Congress should resolve to try to increase the growth through more deficits, interest rates will rise even more. Thus we are caught in a Catch-22 situation. We must bring the deficit down and stop the pressure on the credit markets. This can be done by cutting expenditures even more, or by raising taxes. But both of these will result in less consumer expenditures by reducing the money available to the consumer, thereby dampening economic growth.

There is no single, simple solution to this dilemma. The policies of the past two decades—or more—are responsible for the staggering deficit, with the national debt now over $1 trillion.

The Federal Reserve Board could be blamed for high interest rates and the recession, but they are, in a sense, only responding to a difficult situation created by many years of loose fiscal policies. In today's financial climate it is no longer possible to convince the financial markets overnight that they can expect to get a reasonable return on their investment in real terms—excluding inflation. It takes much longer, and needs much more persuasive evidence.

Such evidence has been apparent for some time. We are definitely winning the race against inflation. And that is a prerequisite to lower interest rates.

THE DEFICIT MUST COME DOWN

Congress must help take the pressure off the financial markets by drastically reducing the deficit.

Record deficits can have nothing but a negative impact on housing. They "crowd" out private demand for capital, keep interest rates high, and tell the financial markets that inflation will continue.

It doesn't matter what the Government spends money for, or where the money comes from, a deficit is a deficit. Put in perspective, this is what has happened to the deficit in the past 50 years:

Fifty years ago the Federal debt was at less than $17 billion; it increased to $1,004 billion by the end of 1981. By fiscal 1985 it is expected to be nearly $1.5 trillion.

During the 25 years from the end of 1956 to the end of 1981, the national debt increased at an average annual rate of 5.3 percent. But that rate of increase in the debt pales in comparison with the burden of the interest cost: the interest cost we are paying has been growing much faster than the Gross National Product. In the late 1950's, the interest cost was equal to 1.4 percent of GNP, rising to 1.6 percent in 1970 and to a record 2.8 percent in 1981. By fiscal 1983 this share of GNP is expected to increase to 3.3 percent, or $133.2 billion. As a comparison, in fiscal 1981 we paid $96 billion for interest on the national debt, while the total expenditures for new housing units were $61.9 billion and for single family units the amount was $43.8 billion.

Combining direct government borrowing with federally assisted borrowing represents a record 36 percent of total borrowing, compared to only 21 percent in the first half of the 1970's and 17 percent during the decade of the 1960's.

It's no wonder we don't have enough money for housing when the Government is taking such an enormous share of the capital markets.

In the struggle for available funds, housing is definitely the loser. In 1979 residential mortgages absorbed $120.2 billion, or 25.3 percent of the total credit market funds raised ($475.8 billion). In addition, other mortgages accounted for 7.5 percent of the total with $35.7 billion, for a total of 32.8 percent.

Last year the residential mortgage share dropped to 14.4 percent ($73.5 billion). Even more dramatic has been the change in the suppliers of mortgage money funds. In the mid-1970's, the thrift institutions provided over 55 percent of all mortgage money. In 1978 their share dropped to just under 40 percent and in the third quarter of 1981, that share fell to a mere 8.8 percent. The share of the sponsored credit agencies, FNMA, Freddie Mac, etc., increased during the same time period from 8.2 percent to 22.7 percent.

The question, therefore, is not so much concerned with what has already happened, rather it is the need to ascertain what types of policies we must have in order to prevent us from perpetuating our mistakes.

For 1982-83 I would like to see higher monetary growth. I say this because I don't believe that the suggested monetary growth is going to be sufficient for any meaningful recovery.

Yet, on the other hand, what do I care what the rate of the money supply is? My primary concern is that we have a sufficient amount to provide us with economic growth and enable interest rates to decline to reasonable levels.

Housing is dying. You have it within your power to heal the patient and help him on the road to recovery. If housing recovers, then perhaps the economic growth we so desperately need will follow.

Attached are numerous tables and charts which clearly illustrates the demise of housing. Also included are NAHB's new forecasts for housing based on the assumption that interest rates will decline (prime to 13 percent in the fourth quarter of 1982)—and a second scenario which assumes that interest rates will not decline (heaven forbid). Further, I have appended an article I wrote last July which outlines my feelings on the "Need to Change the FED's Policies."

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## A Need to Change the Fed's Policies

(By Michael Sumichrast)

There is little outcry from the business or financial communities about the devastating impact of the Federal Reserve Board's policies on the economy. As a matter of fact, there is a great deal of support for the "tight" money policies as one of the main cures of inflation.

However, with interest rates now at record levels—for nearly two years—there are increasing voices heard about the wisdom of the monetarist approach. These voices are particularly strong from the financial community.

Even financial expert Henry Kaufman of Solomon Brothers has some misgivings about the FED's current policies:

"The need is also to recognize that mechanical monetarism should not be the main bulwark against inflation."

The arguments center on the changes in the FED's policies as of October 7, 1979 when the FED virtually abandoned the control of interest rates, and concentrated on controlling the money supply.

Monetary policies have had ample time since then to prove themselves. However, there is sufficient evidence now that these policies are now working well.

In a broad sense, these are the problems:

Money supply, as a target and chief tool of this policy, has been all over the place as the FED cannot hit the money supply target it set for itself.

It's not clear whether the FED knows what the right target should be. Some people think that the growth of money should have a direct relation to the growth of the economy, some think otherwise. What is the right target?

It's not sure whether the FED can clearly define what money is (see box for the current definition of the various money supply measures).

Is money simply that description? Or is it what Bill Gribbs of J. Henry Schroder Bank & Trust Company of New York says it is: "Money is a state of mind. Not what we have on the balance sheet, or in the bank, but how much and can we borrow."

Is the money supply definition more in line with "liquidity," rather than the dollars deposited, or credit?

In a narrower sense, the monetarist approach, combined with a restructuring of the financial intermediaries, has resulted in:

Unprecedented financial instability.

Record high interest rates.

The greatest interest rate fluctuations on record.

Devastating credit sensitive industries and businesses such as housing, farming, small business, auto dealers, etc.

The creation of Friday hysteria—and speculation—on Wall Street in trying to read the money supply figures. Result: financial markets are starting to behave like the stock market with all the irrationality; decisions are precision made, like a finely tuned instrument, and they are made by the minute rather than by the month or the quarter. What possibly could have changed the underlying direction of a huge economy such as ours each Friday afternoon?

This is not the way to go.

How could we have reached a point where we believe that a straight statistical measure of the money supply could possibly be the answer to all our problems? There's more, much more, to it in a complex society like ours. Treating this as a hard science is sheer nonsense. At best, it is an art, requiring a lot of judgments.

For years I have supported the FED's policies. My reasoning was based on the fact that while the U.S. Government tried to spend itself into prosperity, the FED, in many cases, refused to validate this nonsense by restrictive monetary policies. Now, I find that I can no longer support these policies.

At the heart of the current dilemma and controversy is the question of whether or not the FED should have abandoned control of interest rates.

It is not so much a conceptual agreement; most people now would agree that less control is better than more control. It is, however, the enormous impact on real life that such policies have.

If the October 7th experiment had been done in a laboratory, that would have been fine. But it wasn't. These are real people being experimented with: they do or die, just as surely as the mice in the lab who were given the wrong medicine.

The monetarist approach doesn't find any converts overseas, either. The European central banks have followed a dual approach of controlling monetary aggregates (mostly M3) as well as interest rates. The more we stick with controlling the aggregates, the more they would tend to be forced to control rates as a result of the high rates and wide fluctuation in interest rates in the United States.

Nobody is advocating the removal of money supply controls. But a better way of providing more stability in the financial market would be to return to the dual system of controlling interest rates as well as aggregates.

Even setting targets for money supply may be looked at as rather narrow and too simplistic. A more encompassing system may be to look at the total volume of credit availability as a better measure.

The economy should be examined as a mosaic of many parts—a lot of individual sectors. Each of these needs and requires a different approach, and each reacts differently to monetary policies.

It doesn't make much difference to most defense industries what the interest rate is, but it certainly makes a lot difference to a small farmer who needs to buy a tractor on time.

The running of such a massive economy without making some judgments as to its parts, letting it all hang on an imprecise definition of money aggregates, defies common sense.

Currently there is no reality to interest rates. The reason is that not many banks will take a chance to speculate on the downside in a climate of such uncertainty and volatility.

Short term rates should be in the 11-12 percent range, looking strictly at the underlying rate of inflation. Yet, the prime is now at 19.5 percent.

What banks are doing is running for protection by indexing on a weekly or even a daily basis. That alone defies the fundamental working of a free economy. Why should one sector be immune to risks? Why not farmers—or builders? What kind of free competitive system is it if you set interest rates in unison?

Henry Kaufman said: "Financial intermediaries should experience the penalties of monetary restraint and not just pass them along to others. Otherwise, the real world will become the hostage of financial institutions."

MONEY STOCK MEASURES

(in billions of dollars, and percent of total money supply, for April 1981, at seasonal rates)

| M-1A | M-1B | M-2 | M-3 | L | |
|---|---|---|---|---|---|
| $365.1 | $429.5 | $1,733.6 | $2,028.1 | $2,421.2* | |
| 15.1% | 17.7% | 71.6% | 83.8% | 100.0% | |
| Currency | Currency | Currency | Currency | Currency | $ 119.0 |
| + Checking | + Checking | + Checking | +- Checking | + Checking | $ 264.1 |
| | + Checkable Deposits (includes NOW, automatic transfers, credit union shares, and demand deposits at mutual savings banks) | + Checkable Deposits | + Checkable Deposits | + Checkable Deposits | $ 64.4 |
| | | + Small denomination CDs | + Small denomination CDs | + Small denomination CDs | $1,137.2 |
| | | + Eurodollars | + Eurodollars | + Eurodollars | $ 4.7 |
| | | + Overnight repurchase agreements | + Overnight repurchase agreements | + Overnight repurchase agreements | $ 27.1 |
| | | + Money market mutual fund shares | + Money market mutual fund shares | + Money market mutual fund shares | $ 117.1 |
| | | | + Large denomination time deposits | + Large denomination time deposits | $ 258.4 |
| | | | + Term repurchase agreements at commercial banks and S&Ls | + Term repurchase agreements at commercial banks and S&Ls | $ 36.1 |
| | | | | + Other liquid assets not elsewhere classified** | $ 393.1 |

* Data for February 1981

** Other liquid assets: term Eurodollars, savings bonds, short term Treasury securities, bankers acceptances, commercial paper.

Source: Board of Governors of the Federal Reserve System

U.S. HOUSING STARTS RATE PER 1,000 POPULATION, 1900-1983
(with 10 year averages)

| Year | Housing Starts (T) | Popula-tion (M) | Starts Per 1,000 Persons | Year | Housing Starts (T) | Popula-tion (M) | Starts Per 1,000 Persons | Year | Housing Starts (T) | Popula-tion (M) | Starts Per 1,000 Persons |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 1900 | 189 | 76.1 | 2.48 | 1930 | 330 | 123.1 | 2.68 | 1960 | 1,296 | 180.7 | 7.17 |
| 1901 | 275 | 77.6 | 3.54 | 1931 | 254 | 124.1 | 2.05 | 1961 | 1,365 | 183.7 | 7.43 |
| 1902 | 240 | 79.2 | 3.03 | 1932 | 134 | 124.8 | 1.07 | 1962 | 1,492 | 186.6 | 8.00 |
| 1903 | 253 | 80.6 | 3.14 | 1933 | 93 | 125.6 | 0.74 | 1963 | 1,635 | 189.2 | 8.64 |
| 1904 | 315 | 82.2 | 3.83 | 1934 | 126 | 126.4 | 1.00 | 1964 | 1,561 | 191.9 | 8.13 |
| 1905 | 507 | 83.8 | 6.05 | 1935 | 221 | 127.3 | 1.74 | 1965 | 1,510 | 194.3 | 7.77 |
| 1906 | 487 | 85.4 | 5.70 | 1936 | 319 | 128.1 | 2.49 | 1966 | 1,196 | 196.6 | 6.08 |
| 1907 | 432 | 87.0 | 4.97 | 1937 | 336 | 128.8 | 2.61 | 1967 | 1,322 | 198.7 | 6.65 |
| 1908 | 416 | 88.7 | 4.69 | 1938 | 406 | 129.8 | 3.13 | 1968 | 1,545 | 200.7 | 7.70 |
| 1909 | 492 | 90.5 | 5.44 | 1939 | 515 | 130.9 | 3.93 | 1969 | 1,500 | 202.7 | 7.40 |
| 1900-09 | 361 | 83.1 | 4.34 | 1930-39 | 273 | 126.9 | 2.15 | 1960-69 | 1,442 | 192.5 | 7.49 |
| 1910 | 387 | 92.4 | 4.19 | 1940 | 603 | 132.6 | 4.55 | 1970 | 1,469 | 205.1 | 7.16 |
| 1911 | 395 | 93.9 | 4.21 | 1941 | 706 | 133.9 | 5.27 | 1971 | 2,085 | 207.7 | 10.04 |
| 1912 | 426 | 95.3 | 4.47 | 1942 | 356 | 135.4 | 2.63 | 1972 | 2,379 | 209.9 | 11.33 |
| 1913 | 421 | 97.2 | 4.33 | 1943 | 191 | 137.3 | 1.39 | 1973 | 2,058 | 211.9 | 9.71 |
| 1914 | 421 | 99.1 | 4.25 | 1944 | 142 | 138.9 | 1.02 | 1974 | 1,353 | 213.9 | 6.33 |
| 1915 | 433 | 100.5 | 4.31 | 1945 | 326 | 140.5 | 2.32 | 1975 | 1,171 | 216.0 | 5.42 |
| 1916 | 437 | 102.0 | 4.28 | 1946 | 1,023 | 141.9 | 7.21 | 1976 | 1,547 | 218.0 | 7.10 |
| 1917 | 240 | 103.3 | 2.32 | 1947 | 1,268 | 144.7 | 8.76 | 1977 | 2,002 | 220.2 | 9.09 |
| 1918 | 118 | 103.2 | 1.14 | 1948 | 1,362 | 147.2 | 9.25 | 1978 | 2,036 | 222.6 | 9.15 |
| 1919 | 315 | 104.5 | 3.01 | 1949 | 1,466 | 149.8 | 9.79 | 1979 | 1,760 | 225.1 | 7.82 |
| 1910-19 | 359 | 99.1 | 3.62 | 1940-49 | 744 | 140.2 | 5.31 | 1970-79 | 1,786 | 215.0 | 8.31 |
| 1920 | 247 | 106.5 | 2.32 | 1950 | 1,952 | 152.3 | 12.82 | 1980 | 1,313 | 227.7 | 5.77 |
| 1921 | 449 | 108.5 | 4.14 | 1951 | 1,491 | 154.9 | 9.63 | 1981 | 1,101 | 229.8 | 4.79 |
| 1922 | 716 | 110.1 | 6.50 | 1952 | 1,504 | 157.6 | 9.54 | 1982* | 1,074 | 232.0 | 4.63 |
| 1923 | 871 | 112.0 | 7.78 | 1953 | 1,438 | 160.2 | 8.98 | 1983* | 1,497 | 234.2 | 6.39 |
| 1924 | 893 | 114.1 | 7.83 | 1954 | 1,551 | 163.0 | 9.52 | 1984 | | | |
| 1925 | 937 | 115.8 | 8.09 | 1955 | 1,646 | 165.9 | 9.92 | 1985 | | | |
| 1926 | 849 | 117.4 | 7.23 | 1956 | 1,349 | 168.9 | 7.99 | 1986 | | | |
| 1927 | 810 | 119.0 | 6.81 | 1957 | 1,224 | 172.0 | 7.12 | 1987 | | | |
| 1928 | 753 | 120.5 | 6.25 | 1958 | 1,382 | 174.9 | 7.90 | 1988 | | | |
| 1929 | 509 | 121.8 | 4.18 | 1959 | 1,554 | 177.8 | 8.74 | 1989 | | | |
| 1920-29 | 703 | 114.6 | 6.13 | 1950-59 | 1,509 | 164.8 | 9.16 | 1980-89 | | | |

Code: (T)=in thousands; (M)=in millions
* Forecasted
Source: Bureau of the Census; NAHB Forecasting Service; compilation by NAHB Economics Division

February 2, 1982

SALE OF NEW HOMES
(percent of respondents)

| | Single Family Detached | | | Townhouse | | | Condominium | | |
|---|---|---|---|---|---|---|---|---|---|
| | Good to Excellent | Fair | Poor | Good to Excellent | Fair | Poor | Good to Excellent | Fair | Poor |
| **Next Six Months** | | | | | | | | | |
| Jan 1982 | 1% | 32% | 67% | 2% | 39% | 59% | 5% | 34% | 61% |
| **Current** | | | | | | | | | |
| Jan 1982 | 0% | 12% | 88% | 0% | 20% | 80% | 1% | 25% | 74% |
| Nov 1981 | *% | 6% | 94% | 0% | 13% | 87% | *% | 16% | 84% |
| Aug 1981 | 2 | 10 | 88 | 3 | 19 | 78 | 6 | 23 | 71 |
| May 1981 | 4 | 12 | 84 | 5 | 31 | 64 | 13 | 20 | 67 |
| Apr 1981 | 5 | 22 | 73 | 11 | 35 | 54 | 10 | 43 | 47 |
| Mar 1981 | 3 | 18 | 79 | 0 | 32 | 68 | 4 | 50 | 46 |
| Feb 1981 | 0 | 15 | 85 | 0 | 29 | 71 | 0 | 33 | 67 |
| Jan 1981 | 3 | 17 | 80 | 3 | 26 | 71 | 9 | 32 | 59 |
| Nov 1980 | 3 | 20 | 77 | 7 | 26 | 67 | 6 | 37 | 57 |
| Oct 1980 | 6 | 38 | 56 | 12 | 44 | 44 | 12 | 52 | 36 |
| Sep 1980 | 12 | 35 | 53 | 15 | 45 | 40 | 14 | 43 | 43 |
| Aug 1980 | 11 | 41 | 49 | 8 | 46 | 46 | 7 | 44 | 49 |
| Jul 1980 | 5 | 36 | 59 | 11 | 35 | 54 | 12 | 34 | 54 |
| May 1980 | 5 | 25 | 70 | 8 | 20 | 72 | 5 | 29 | 66 |
| Apr 1980 | 2 | 14 | 83 | 2 | 22 | 76 | 3 | 28 | 69 |
| Mar 1980 | 1 | 12 | 87 | 4 | 10 | 86 | 6 | 11 | 83 |
| Feb 1980 | 0 | 44 | 56 | 1 | 49 | 50 | 0 | 50 | 40 |
| Jan 1980 | 10 | 29 | 61 | 7 | 31 | 62 | 12 | 35 | 53 |
| Dec 1979 | 7% | 21% | 72% | 7% | 27% | 66% | 14% | 25% | 61% |
| Oct 1979 | 11 | 36 | 53 | 12 | 35 | 53 | 12 | 44 | 44 |
| Aug 1979 | 29 | 44 | 27 | 27 | 50 | 23 | 37 | 40 | 23 |
| Jul 1979 | 26 | 46 | 28 | 28 | 39 | 33 | 37 | 33 | 30 |
| Jun 1979 | 28 | 37 | 35 | 24 | 42 | 34 | 25 | 48 | 27 |
| May 1979 | 53 | 26 | 22 | 60 | 25 | 15 | 60 | 26 | 14 |
| Apr 1979 | 55 | 25 | 20 | 55 | 15 | 30 | 48 | 30 | 22 |
| Feb 1979 | 31 | 51 | 18 | 20 | 46 | 34 | 20 | 42 | 38 |
| Sep 1978 | 46% | 39% | 13% | 38% | 40% | 22% | 32% | 38% | 30% |
| Jun 1978 | 64 | 28 | 8 | 26 | 44 | 30 | 25 | 36 | 39 |
| Mar 1978 | 68 | 27 | 5 | 31 | 38 | 31 | 21 | 40 | 39 |
| Nov 1977 | 69% | 29% | 2% | 28% | 40% | 32% | 17% | 32% | 51% |
| Aug 1977 | 79 | 17 | 4 | 23 | 44 | 33 | 21 | 33 | 46 |
| Mar 1977 | 72 | 21 | 7 | 20 | 49 | 31 | 12 | 35 | 53 |
| Nov 1976 | 45% | 44% | 11% | 11% | 22% | 67% | 9% | 17% | 74% |

* Less than 1 percent

Source: BEC Survey, NAHB Economics Division

SEASONALLY ADJUSTED CONSUMER PRICE INDEX FOR ALL URBAN CONSUMERS: U.S. CITY AVERAGE, 1978-1981 (1967 = 100)

| | Consumer Price Index | Monthly Rate of Change | Annual Rate of Change Compounded | Not Compounded |
|---|---|---|---|---|
| 1978 | | | | |
| Jan | 187.9 | 0.6% | 7.5% | 7.2% |
| Feb | 188.9 | 0.5 | 6.6 | 6.0 |
| Mar | 190.2 | 0.7 | 8.6 | 8.4 |
| Apr | 191.5 | 0.7 | 8.5 | 8.4 |
| May | 193.1 | 0.8 | 10.5 | 9.6 |
| Jun | 194.8 | 0.9 | 11.1 | 10.8 |
| Jul | 196.2 | 0.7 | 9.0 | 8.4 |
| Aug | 197.5 | 0.7 | 8.2 | 8.4 |
| Sep | 199.3 | 0.9 | 11.5 | 10.8 |
| Oct | 201.1 | 0.9 | 11.4 | 10.8 |
| Nov | 202.5 | 0.7 | 8.7 | 8.4 |
| Dec | 203.8 | 0.6 | 8.0 | 7.2 |
| 1979 | | | | |
| Jan | 205.5 | 0.8% | 10.5% | 9.6% |
| Feb | 207.6 | 1.0 | 13.0 | 12.0 |
| Mar | 209.5 | 0.9 | 11.6 | 10.8 |
| Apr | 211.5 | 1.0 | 12.1 | 12.0 |
| May | 213.7 | 1.0 | 13.2 | 12.0 |
| Jun | 215.9 | 1.0 | 13.1 | 12.0 |
| Jul | 218.4 | 1.2 | 14.8 | 13.2 |
| Aug | 220.7 | 1.0 | 13.4 | 12.0 |
| Sep | 223.3 | 1.2 | 15.1 | 14.4 |
| Oct | 225.7 | 1.1 | 13.7 | 13.2 |
| Nov | 228.4 | 1.2 | 15.3 | 14.4 |
| Dec | 230.9 | 1.1 | 14.0 | 13.2 |
| 1980 | | | | |
| Jan | 234.1 | 1.4% | 18.0% | 16.8% |
| Feb | 237.1 | 1.3 | 16.5 | 15.6 |
| Mar | 240.3 | 1.4 | 17.5 | 16.8 |
| Apr | 242.4 | 0.9 | 11.0 | 10.8 |
| May | 244.5 | 0.9 | 10.9 | 10.8 |
| Jun | 246.9 | 1.0 | 12.4 | 12.0 |
| Jul | 247.1 | 0.1 | 1.0 | 1.2 |
| Aug | 249.0 | 0.8 | 9.6 | 9.6 |
| Sep | 251.6 | 1.0 | 13.3 | 12.0 |
| Oct | 254.2 | 1.0 | 13.1 | 12.0 |
| Nov | 257.0 | 1.1 | 14.0 | 13.2 |
| Dec | 259.5 | 1.0 | 12.3 | 12.0 |
| 1981 | | | | |
| Jan | 261.4 | 0.7% | 9.1% | 8.4% |
| Feb | 263.9 | 1.0 | 12.1 | 12.0 |
| Mar | 265.5 | 0.6 | 7.5 | 7.2 |
| Apr | 266.7 | 0.4 | 5.6 | 4.8 |
| May | 268.4 | 0.7 | 7.9 | 8.4 |
| Jun | 270.3 | 0.7 | 8.8 | 8.4 |
| Jul | 273.5 | 1.2 | 15.2 | 14.4 |
| Aug | 275.8 | 0.8 | 10.6 | 9.6 |
| Sep | 279.0 | 1.2 | 14.8 | 14.4 |
| Oct | 280.0 | 0.4 | 4.4 | 4.8 |
| Nov | 281.3 | 0.5 | 5.7 | 6.0 |
| Dec | 282.6 | 0.5 | 5.7 | 6.0 |

SOURCE: Bureau of Labor Statistics; Compiled by NAHB Economics Division

## 1981-82 PRODUCER PRICE INDICES
(unadjusted, 1967=100)

| | 1981 | | | | | | | | | | 1982 | Jan 81 Jan 82 | Dec 81 Jan 82 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Jan | Apr | May | Jun | Jul | Aug | Sep | Oct | Nov | Dec | Jan | % Chg. | % Chg. |
| All Commodities | 283.5 | 292.8 | 293.7 | 294.5 | 296.0 | 296.2 | 295.5 | 296.0 | 295.5 | 295.9 | 298.2 | 5.2% | 0.8% |
| All Const. Materials | 276.7 | 283.4 | 284.1 | 284.8 | 285.4 | 285.6 | 284.4 | 284.5 | 284.1 | 285.1 | 286.4 | 3.5 | 0.5 |
| Prepared Paint | 243.3 | 248.5 | 250.4 | 250.4 | 251.0 | 251.0 | 251.0 | 251.0 | 254.8 | 256.7 | 259.3 | 6.6 | 1.0 |
| Softwood Lumber | 353.4 | 352.5 | 356.4 | 356.1 | 349.0 | 347.7 | 335.2 | 324.8 | 319.9 | 321.4 | 322.3 | -8.8 | 0.3 |
| Douglas Fir | 349.5 | 333.7 | 328.7 | 333.4 | 320.4 | 318.2 | 295.3 | 276.1 | 268.2 | 269.3 | 269.1 | -23.0 | -0.1 |
| Southern Pine | 292.3 | 299.0 | 307.0 | 304.6 | 289.9 | 287.8 | 277.0 | 271.4 | 271.2 | 277.0 | 278.0 | -4.9 | 0.4 |
| Other Softwood | 380.8 | 384.0 | 392.9 | 391.4 | 389.6 | 390.9 | 378.6 | 367.0 | 357.9 | 357.7 | 360.0 | -5.5 | 0.6 |
| General Millwork | 283.6 | 287.3 | 284.8 | 282.2 | 283.3 | 280.3 | 278.8 | 279.4 | 280.5 | 283.7 | 288.1 | 1.6 | 1.6 |
| Prefab Struct. Members | 236.0 | 237.2 | 237.2 | 237.2 | 236.6 | 239.8 | 239.6 | 237.9 | 237.9 | 235.9 | 236.2 | 0.1 | 0.1 |
| Softwood Plywood | 325.2 | 322.5 | 314.9 | 319.2 | 312.7 | 303.0 | 294.6 | 278.3 | 277.7 | 289.3 | 283.2 | -12.9 | -2.1 |
| Insulation Board | 230.7 | 242.4 | 246.7 | 248.0 | 241.8 | 245.1 | 243.4 | 244.1 | 244.4 | 246.5 | 246.3 | 6.8 | -0.1 |
| Steel Mill Products | 322.7 | 331.8 | 332.0 | 332.1 | 344.9 | 344.9 | 345.3 | 348.7 | 348.6 | 348.9 | 350.8 | 8.7 | 0.5 |
| Structural Shapes | 343.8 | 371.0 | 371.0 | 370.0 | 369.4 | 369.4 | 369.4 | 388.5 | 388.5 | 389.5 | 389.5 | 13.3 | 0.0 |
| Bars, Reinforcing | 276.0 | 279.0 | 278.5 | 277.8 | 276.2 | 275.6 | 275.1 | 273.7 | 270.2 | 270.2 | 268.7 | -2.6 | -0.6 |
| Nails, Wire 8D Common | 346.6 | 345.0 | 354.5 | 354.5 | 365.8 | 365.8 | 365.8 | 365.8 | 365.8 | 367.7 | 367.7 | 6.1 | 0.0 |
| Mill Shapes | 297.2 | 301.1 | 302.5 | 304.5 | 305.7 | 307.4 | 307.2 | 308.9 | 306.4 | 305.5 | 304.9 | 2.6 | -0.2 |
| Copper/Brass Mill Shapes | 224.3 | 220.9 | 222.5 | 221.6 | 220.3 | 222.0 | 222.2 | 222.8 | 219.3 | 217.7 | 216.8 | -3.3 | -0.4 |
| Hardware NEC | 237.0 | 238.4 | 239.0 | 239.4 | 242.2 | 242.5 | 245.4 | 247.5 | 248.6 | 249.2 | 250.5 | 5.7 | 0.5 |
| Builders Hardware | 249.4 | 251.1 | 252.8 | 253.6 | 256.6 | 257.4 | 260.1 | 262.3 | 265.0 | 266.1 | 268.9 | 7.8 | 1.1 |
| Plumb. Fixt./Brass Fitngs. | 255.5 | 265.2 | 265.6 | 268.2 | 270.3 | 271.0 | 271.4 | 272.8 | 273.0 | 273.9 | 274.4 | 7.4 | 0.2 |
| Vitreous China Fixtures | 245.4 | 252.8 | 253.3 | 256.7 | 259.6 | 260.4 | 259.8 | 259.7 | 260.0 | 260.8 | 261.8 | 6.7 | 0.4 |
| Brass Fittings | 259.0 | 270.6 | 270.8 | 273.9 | 275.2 | 275.1 | 275.7 | 277.8 | 277.8 | 279.1 | 279.5 | 7.9 | 0.1 |
| Heating Equipment | 215.4 | 218.8 | 221.7 | 222.9 | 225.7 | 227.2 | 227.9 | 228.4 | 227.6 | 229.2 | 232.2 | 7.8 | 1.3 |
| Water Heaters-Domestic | 215.5 | 215.8 | 215.9 | 216.9 | 218.5 | 222.6 | 222.6 | 223.1 | 217.2 | 216.7 | 224.2 | 4.0 | 3.5 |
| Fab. Struc. Steel, Bldgs. | 284.7 | 298.9 | 298.9 | 300.2 | 300.2 | 300.2 | 302.3 | 310.4 | 310.4 | NA | NA | NA | NA |
| Flat Glass | 203.9 | 208.1 | 208.1 | 208.1 | 216.2 | 218.8 | 218.8 | 218.5 | 218.5 | 218.5 | 216.0 | 5.9 | -1.1 |
| Portland Cement | 319.1 | 328.9 | 329.1 | 328.9 | 329.4 | 329.4 | 328.8 | 327.1 | 327.0 | 327.0 | 336.3 | 5.4 | 2.8 |
| Concrete Block & Brick | 263.4 | 266.6 | 270.6 | 270.6 | 270.5 | 273.8 | 273.8 | 272.9 | 273.5 | 274.3 | 274.4 | 4.2 | 0.0 |
| Ready-Mix Concrete | 295.4 | 299.7 | 300.5 | 303.2 | 301.8 | 301.1 | 300.7 | 300.9 | 300.2 | 300.4 | 302.1 | 2.3 | 0.6 |
| Building Brick | 291.1 | 301.1 | 302.2 | 302.2 | 303.7 | 303.8 | 304.2 | 304.1 | 304.8 | 305.1 | 305.1 | 4.8 | 0.0 |
| Clay Tile | 187.8 | 187.8 | 191.2 | 191.2 | 191.2 | 191.2 | 203.3 | 203.3 | 203.3 | 203.3 | 203.3 | 8.3 | 0.0 |
| Prepared Asphalt Roofing | 374.8 | 367.2 | 358.1 | 370.8 | 367.4 | 365.9 | 348.2 | 349.7 | 359.4 | 353.5 | 347.8 | -7.2 | -1.6 |
| Gypsum Products | 259.6 | 256.8 | 261.1 | 260.7 | 259.7 | 255.3 | 252.9 | 252.4 | 251.3 | 249.7 | 250.4 | -3.5 | 0.3 |
| Paving Mixtures & Block | 522.1 | 616.9 | 610.7 | 610.1 | 608.6 | 607.0 | 599.1 | 597.0 | 597.5 | 597.7 | 596.0 | 14.2 | -0.3 |
| Major Appliances | 183.6 | 185.8 | 186.1 | 186.9 | 189.9 | 190.3 | 191.3 | 192.5 | 192.8 | 193.1 | 195.1 | 6.3 | 1.0 |

Source: Department of Labor, Bureau of Labor Statistics. Compilation and analysis by NAHB Economics Division.

CREDIT MARKET FUNDS RAISED, 1946-1981
(in billions of dollars)

DOLLAR VOLUME

| Year | Total Credit Market Debt | U.S. Govt. Securities | State & Local Government Obligations | Corporate & Foreign Bonds | Mortgages: Residential | Mortgages: Other | Consumer Credit | Bank Loans N.E.C. | Open Market Paper | Other Loans |
|---|---|---|---|---|---|---|---|---|---|---|
| 1946 | $ -4.8 | $-23.2 | $ 0.1 | $ 1.0 | $ 4.8 | $ 1.4 | $ 2.7 | $ 5.3 | $ 0.3 | $ 2.7 |
| 1950 | 27.0 | -0.8 | 3.3 | 2.2 | 9.0 | 1.1 | 4.8 | 5.9 | 0.2 | 1.3 |
| 1955 | 41.4 | 0.2 | 5.3 | 3.6 | 13.4 | 2.8 | 7.2 | 7.3 | -0.2 | 1.8 |
| 1960 | 39.6 | -1.7 | 5.3 | 5.4 | 13.1 | 4.0 | 4.4 | 3.6 | 2.2 | 3.3 |
| 1965 | 80.4 | 3.9 | 7.3 | 8.1 | 20.7 | 6.7 | 10.6 | 15.8 | 0.9 | 6.4 |
| 1970 | 108.4 | 21.7 | 11.2 | 23.3 | 25.9 | 4.0 | 5.4 | 7.3 | 2.1 | 7.5 |
| 1971 | 154.5 | 30.9 | 17.4 | 24.7 | 39.8 | 12.7 | 14.7 | 11.0 | -0.1 | 3.5 |
| 1972 | 191.3 | 23.6 | 14.7 | 20.3 | 56.5 | 20.3 | 19.8 | 26.1 | 1.6 | 8.4 |
| 1973 | 239.0 | 28.3 | 14.7 | 14.6 | 55.3 | 24.6 | 24.3 | 48.8 | 8.3 | 20.2 |
| 1974 | 225.1 | 31.9 | 16.5 | 24.9 | 40.2 | 20.3 | 9.9 | 41.3 | 17.7 | 22.5 |
| 1975 | 210.9 | 94.9 | 16.1 | 36.7 | 41.4 | 15.8 | 9.6 | -12.2 | -1.2 | 9.8 |
| 1976 | 286.4 | 84.6 | 15.7 | 41.2 | 69.6 | 17.6 | 25.4 | 6.2 | 8.1 | 17.8 |
| 1977 | 382.2 | 79.9 | 21.9 | 36.1 | 106.7 | 25.6 | 40.2 | 29.5 | 15.0 | 27.4 |
| 1978 | 471.1 | 90.5 | 26.1 | 31.6 | 118.6 | 29.7 | 47.6 | 59.0 | 26.4 | 41.5 |
| 1979 | 475.8 | 85.7 | 21.8 | 32.9 | 120.2 | 35.7 | 46.3 | 51.0 | 40.5 | 41.9 |
| 1980 | 417.4 | 122.3 | 26.9 | 38.4 | 89.4 | 31.7 | 2.3 | 48.4 | 21.4 | 36.7 |
| 1981** | 511.0 | 129.3 | 23.7 | 16.1 | 73.5 | 31.0 | 31.9 | 70.4 | 69.2 | 65.9 |

PERCENT DISTRIBUTION

| Year | Total Credit Market Debt | U.S. Govt. Securities | State & Local Government Obligations | Corporate & Foreign Bonds | Mortgages: Residential | Mortgages: Other | Consumer Credit | Bank Loans N.E.C. | Open Market Paper | Other Loans |
|---|---|---|---|---|---|---|---|---|---|---|
| 1946 | 100.0% | N/M | N/M | N/M | N/M | N/M | N/M | N/M | N/M | N/M |
| 1950 | 100.0 | 2.9% | 12.2% | 8.1% | 33.3% | 4.1% | 17.8% | 21.9% | 0.7% | 4.8% |
| 1955 | 100.0 | 0.5 | 12.8 | 8.7 | 32.4 | 6.7 | 17.4 | 17.6 | -0.5 | 4.3 |
| 1960 | 100.0 | -4.2 | 13.4 | 13.6 | 33.1 | 10.1 | 11.1 | 9.1 | 5.6 | 8.3 |
| 1965 | 100.0 | 4.9 | 9.1 | 10.1 | 25.8 | 8.3 | 13.2 | 19.6 | 1.1 | 7.9 |
| 1970 | 100.0 | 20.0 | 10.3 | 21.5 | 23.9 | 3.7 | 5.0 | 6.7 | 1.9 | 6.9 |
| 1971 | 100.0 | 20.0 | 11.3 | 16.0 | 25.8 | 8.2 | 9.5 | 7.1 | * | 2.2 |
| 1972 | 100.0 | 12.3 | 7.7 | 10.6 | 29.5 | 10.6 | 10.4 | 13.6 | 0.8 | 4.4 |
| 1973 | 100.0 | 11.8 | 6.2 | 6.1 | 23.1 | 10.3 | 10.2 | 20.4 | 3.5 | 8.4 |
| 1974 | 100.0 | 14.2 | 7.3 | 11.1 | 17.9 | 9.0 | 4.4 | 18.3 | 7.9 | 10.0 |
| 1975 | 100.0 | 45.0 | 7.6 | 17.4 | 19.6 | 7.5 | 4.5 | -5.8 | -0.6 | 4.6 |
| 1976 | 100.0 | 29.5 | 5.5 | 14.4 | 24.3 | 6.1 | 8.9 | 2.2 | 2.8 | 6.2 |
| 1977 | 100.0 | 20.9 | 5.7 | 9.4 | 27.9 | 6.7 | 10.5 | 7.7 | 3.9 | 7.2 |
| 1978 | 100.0 | 19.2 | 5.5 | 6.7 | 25.2 | 6.3 | 10.1 | 12.5 | 5.6 | 8.8 |
| 1979 | 100.0 | 18.0 | 4.6 | 6.9 | 25.3 | 7.5 | 9.7 | 10.7 | 8.5 | 8.8 |
| 1980 | 100.0 | 29.3 | 6.4 | 9.2 | 21.4 | 7.6 | 0.6 | 11.6 | 5.1 | 8.8 |
| 1981** | 100.0 | 25.3 | 4.6 | 3.2 | 14.4 | 6.1 | 6.2 | 13.8 | 13.5 | 12.9 |

N/M Not measurable
* Less than one-tenth of one percent
** 1981 data is based on the average of the first three quarters of 1981 at seasonally adjusted annual rates.

SOURCE: Board of Governors of the Federal Reserve System, Flow of Funds Accounts, various issues; compilation by NAHB Economics Division.

TOTAL MORTGAGE FUNDS ADVANCED
(In billions of dollars)

| | 1946 | 1950 | 1955 | 1960 | 1965 | 1970 | 1971 | 1972 | 1973 | 1974 | 1975 | 1976 | 1977 | 1978 | 1979 | 1980 | 1981 | 1981 Q 1 | 1981 Q 2 | 1981 Q 3 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| I By Type of Mortgage | | | | | | | | | | | | | | | | | | | | |
| A. Total Dollar Volume | $ 6.2 | $ 10.1 | $ 16.2 | $ 17.1 | $ 27.4 | $ 29.9 | $ 52.5 | $ 76.8 | $ 79.9 | $ 60.5 | $ 57.2 | $ 87.2 | $132.3 | $148.1 | $155.9 | $121.1 | $104.5 | $112.3 | $109.5 | $ 91.8 |
| Home Mortgages | 4.4 | 7.5 | 12.6 | 11.1 | 17.1 | 15.0 | 29.9 | 43.7 | 44.9 | 33.3 | 41.4 | 65.7 | 99.4 | 109.1 | 112.5 | 81.0 | 68.4 | 77.3 | 70.9 | 56.9 |
| Multifamily Residential | 0.4 | 1.5 | 0.8 | 2.1 | 3.6 | 6.9 | 9.9 | 12.8 | 10.4 | 6.9 | NA | 3.9 | 7.3 | 9.3 | 7.7 | 8.4 | 5.1 | 4.9 | 5.2 | 5.3 |
| Commercial | 1.3 | 0.6 | 2.0 | 3.2 | 4.4 | 7.2 | 10.3 | 16.8 | 19.3 | 15.3 | 11.2 | 11.9 | 18.5 | 22.1 | 24.4 | 22.3 | 20.5 | 20.5 | 23.7 | 17.3 |
| Farm | 0.1 | 0.5 | 0.8 | 0.7 | 2.3 | 0.8 | 2.4 | 3.6 | 5.5 | 5.0 | 4.6 | 5.7 | 7.1 | 7.5 | 11.3 | 9.5 | 10.5 | 9.7 | 9.7 | 12.3 |
| B. Percent Distribution | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% |
| Home Mortgages | 71.0 | 74.3 | 77.8 | 64.9 | 62.4 | 50.2 | 57.0 | 56.9 | 56.2 | 55.0 | 72.4 | 75.1 | 75.3 | 73.7 | 72.2 | 66.9 | 65.5 | 68.8 | 64.7 | 62.0 |
| Multifamily Residential | 6.5 | 14.8 | 4.9 | 12.3 | 13.1 | 23.1 | 18.8 | 16.6 | 13.0 | 11.4 | NA | 4.5 | 5.5 | 6.3 | 4.9 | 6.9 | 4.9 | 4.4 | 4.7 | 5.8 |
| Commercial | 21.0 | 5.9 | 12.3 | 18.7 | 16.1 | 24.1 | 19.6 | 21.9 | 23.9 | 25.3 | 19.6 | 13.6 | 14.0 | 14.9 | 15.7 | 18.4 | 19.6 | 18.2 | 21.6 | 18.9 |
| Farm | 1.6 | 5.0 | 4.9 | 4.1 | 8.4 | 2.7 | 4.6 | 4.6 | 6.9 | 8.1 | 8.0 | 6.5 | 5.4 | 5.1 | 7.2 | 7.8 | 10.0 | 8.6 | 8.9 | 13.4 |
| II By Holder of Mortgage | | | | | | | | | | | | | | | | | | | | |
| A. Total Dollar Volume | $ 6.2 | $ 10.1 | $ 16.2 | $ 17.1 | $ 27.4 | $ 29.9 | $ 52.5 | $ 76.8 | $ 79.9 | $ 60.5 | $ 57.2 | $ 87.2 | $132.3 | $148.1 | $155.9 | $121.1 | $104.5 | $112.3 | $109.5 | $ 91.8 |
| Households | 1.5 | 0.7 | 1.1 | 2.7 | 0.5 | 1.6 | 1.3 | 4.4 | 3.4 | 4.3 | 3.7 | 7.6 | 10.8 | 11.7 | 12.4 | 8.1 | 7.2 | 6.3 | 7.9 | 7.4 |
| State/Local Govt. Gen. Funds | * | 0.1 | 0.1 | 0.2 | 0.2 | 0.9 | 1.1 | 1.4 | 1.7 | 2.5 | 1.6 | 1.3 | 0.6 | 2.3 | 6.3 | 9.5 | 8.0 | 8.1 | 7.6 | 8.4 |
| U.S. Government | -0.3 | 0.3 | 0.2 | 0.2 | -0- | 0.1 | -0.4 | -0.7 | -0.6 | 3.8 | 6.5 | 0.4 | 4.2 | 4.2 | 6.6 | 7.5 | 6.8 | 4.7 | 8.9 | 6.7 |
| Sponsored Credit Agencies | -0.1 | * | 0.5 | 1.1 | 1.1 | 5.3 | 3.6 | 4.0 | 7.2 | 10.2 | 5.3 | 2.9 | 3.5 | 12.2 | 14.4 | 14.1 | 12.3 | 4.3 | 11.8 | 20.8 |
| Mortgage Pools | -0- | * | * | -0- | 0.3 | 1.6 | 4.8 | 4.9 | 3.6 | 3.4 | 7.1 | 12.2 | 16.1 | 13.6 | 24.0 | 18.6 | 12.1 | 17.2 | 12.1 | 7.1 |
| Private Financial Institutions | 5.1 | 9.0 | 14.4 | 12.9 | 25.4 | 20.1 | 42.1 | 60.8 | 64.6 | 36.4 | 33.0 | 62.9 | 97.2 | 106.3 | 92.1 | 63.3 | 58.1 | 71.7 | 61.2 | 41.3 |
| Commercial Banking | 2.5 | 2.0 | 2.4 | 0.7 | 5.7 | 2.2 | 9.8 | 16.8 | 19.8 | 12.8 | 3.8 | 15.1 | 27.7 | 35.1 | 30.6 | 19.4 | 26.7 | 22.7 | 25.9 | 25.5 |
| Savings Institutions | 2.0 | 3.6 | 7.8 | 8.9 | 13.1 | 11.7 | 27.6 | 37.4 | 32.7 | 19.8 | 32.1 | 49.3 | 64.9 | 59.2 | 47.3 | 29.0 | 21.9 | 36.2 | 21.1 | 8.1 |
| S&L Associations | 1.8 | 2.0 | 5.3 | 7.0 | 9.0 | 9.8 | 23.6 | 31.8 | 26.5 | 17.6 | 29.5 | 44.4 | 58.2 | 51.6 | 43.1 | 27.7 | 20.5 | 33.5 | 21.3 | 6.8 |
| Mutual Savings Banks | 0.2 | 1.6 | 2.5 | 1.9 | 4.0 | 1.8 | 3.9 | 5.5 | 5.7 | 2.2 | 2.1 | 4.4 | 6.5 | 7.1 | 3.6 | 0.8 | 0.8 | 0.2 | 1.5 | 0.8 |
| Credit Unions | * | -0- | * | 0.1 | 0.1 | 0.1 | * | 0.2 | 0.4 | 0.1 | 0.5 | 0.5 | 0.3 | 0.6 | 0.6 | 0.5 | 0.6 | 0.6 | 0.6 | 0.6 |
| Insurance | 0.5 | 3.2 | 3.6 | 3.4 | 6.1 | 2.7 | 1.0 | 0.7 | 4.7 | 5.4 | 2.8 | 2.6 | 5.8 | 10.2 | 14.2 | 14.6 | 11.0 | 11.8 | 11.8 | 9.3 |
| Life Insurance Companies | 0.5 | 3.2 | 3.5 | 2.8 | 4.9 | 2.4 | 1.1 | 1.5 | 4.4 | 4.9 | 2.9 | 2.4 | 5.2 | 9.4 | 12.6 | 12.6 | 9.2 | 10.6 | 9.4 | 7.7 |
| Private Pension Funds | * | * | 0.1 | 0.3 | 0.6 | -0- | -0.5 | -0.9 | -0.4 | * | * | * | 0.1 | 0.3 | 0.3 | 0.6 | 0.2 | -0.1 | 0.4 | 0.3 |
| State/Local Gov. Ret. Funds | * | * | * | 0.5 | 0.6 | 0.3 | 0.4 | 0.2 | 0.7 | 0.6 | -0.2 | 0.2 | 0.3 | 0.5 | 1.0 | 1.3 | 1.4 | 1.1 | 1.8 | 1.3 |
| Other Insurance Companies | * | * | * | -0- | -0- | -0- | * | * | * | * | 0.1 | 0.1 | 0.1 | * | 0.3 | 0.4 | 0.2 | 0.2 | 0.3 | 0.1 |
| Finance Companies | 0.1 | 0.2 | 0.6 | -0- | 0.5 | 1.7 | 1.5 | 1.7 | 1.9 | -1.9 | -1.3 | -0.4 | 1.2 | 0.9 | 1.0 | 1.0 | 1.1 | 3.3 | 1.4 | -1.3 |
| REITS | — | — | — | — | — | 1.8 | 2.3 | 4.2 | 5.6 | 0.2 | -4.8 | -3.8 | -2.4 | -1.1 | -1.0 | -0.7 | -0.7 | -0.3 | -1.3 | -0.4 |
| B. Percent Distribution | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% |
| Households | 24.2 | 6.9 | 8.0 | 15.8 | 1.8 | 5.4 | 2.5 | 8.1 | 4.3 | 7.1 | 6.5 | 8.7 | 8.2 | 7.9 | 8.0 | 6.7 | 6.9 | 5.6 | 7.2 | 8.1 |
| State/Local Govt. Gen. Funds | * | 1.0 | 0.6 | 1.2 | 0.7 | 1.0 | 2.1 | 1.8 | 2.1 | 4.1 | 2.8 | 1.5 | 0.6 | 1.6 | 4.0 | 7.8 | 7.6 | 7.2 | 6.9 | 9.2 |
| U.S. Government | -4.8 | 3.0 | 1.2 | 1.2 | -0- | 1.0 | -0.8 | -0.9 | -0.8 | 6.3 | 11.4 | 0.4 | 3.2 | 2.8 | 4.2 | 6.2 | 6.5 | 4.2 | 8.1 | 7.3 |
| Sponsored Credit Agencies | -1.6 | * | 1.8 | 6.4 | 4.0 | 17.8 | 6.9 | 5.2 | 9.0 | 16.8 | 9.1 | 3.3 | 2.6 | 8.2 | 9.2 | 11.6 | 11.8 | 3.8 | 10.8 | 22.7 |
| Mortgage Pools | -0- | * | * | -0- | 1.1 | 5.4 | 9.1 | 6.4 | 4.5 | 5.6 | 12.4 | 14.0 | 12.2 | 9.2 | 15.4 | 15.4 | 11.6 | 15.3 | 11.1 | 7.7 |
| Private Financial Institutions | 82.3 | 89.1 | 88.3 | 75.4 | 92.4 | 67.4 | 80.2 | 79.2 | 80.9 | 60.2 | 57.7 | 72.1 | 73.5 | 70.3 | 59.1 | 52.3 | 55.6 | 63.8 | 55.9 | 45.0 |
| Commercial Banking | 40.3 | 19.8 | 14.7 | 4.1 | 20.7 | 7.4 | 18.7 | 21.9 | 24.8 | 21.2 | 6.7 | 17.3 | 20.9 | 23.7 | 19.6 | 18.0 | 23.6 | 20.2 | 23.7 | 27.8 |
| Savings Institutions | 32.1 | 35.6 | 47.8 | 52.0 | 47.6 | 39.3 | 52.6 | 48.7 | 40.9 | 32.7 | 56.5 | 56.5 | 49.1 | 39.9 | 30.3 | 23.9 | 21.0 | 30.5 | 21.3 | 8.8 |
| S&L Associations | 29.0 | 19.8 | 32.5 | 40.9 | 32.7 | 32.9 | 45.0 | 41.4 | 33.2 | 29.1 | 51.6 | 50.9 | 44.0 | 34.8 | 27.6 | 22.9 | 19.6 | 29.8 | 19.4 | 7.4 |
| Mutual Savings Banks | 3.2 | 15.8 | 15.3 | 11.1 | 14.5 | 6.0 | 7.4 | 7.2 | 7.1 | 3.6 | 4.0 | 5.0 | 4.9 | 4.8 | 2.3 | 0.7 | 0.8 | 0.2 | 1.4 | 0.9 |
| Credit Unions | * | -0- | * | 0.6 | 0.4 | 0.3 | * | 0.3 | 0.5 | 0.2 | 0.9 | 0.6 | 0.2 | 0.4 | 0.4 | 0.4 | 0.6 | 0.5 | 0.5 | 0.7 |
| Insurance | 8.1 | 31.7 | 22.1 | 19.9 | 22.2 | 9.1 | 1.9 | 0.9 | 5.9 | 8.9 | 4.9 | 3.0 | 4.4 | 6.9 | 9.1 | 12.1 | 10.5 | 10.5 | 10.8 | 10.1 |
| Life Insurance Companies | 8.1 | 31.7 | 21.5 | 15.2 | 17.8 | 8.1 | 2.1 | 1.9 | 5.5 | 8.1 | 5.1 | 2.7 | 3.9 | 6.3 | 8.1 | 10.2 | 8.8 | 9.4 | 8.6 | 8.6 |
| Private Pension Funds | * | * | 0.6 | 1.7 | 2.2 | -0- | -1.0 | -1.2 | -0.5 | * | * | * | 0.1 | 0.2 | 0.2 | 0.5 | 0.2 | -0.1 | 0.4 | 0.3 |
| State/Local Gov. Ret. Funds | * | * | * | 2.9 | 2.2 | 1.0 | 0.8 | 0.3 | 0.9 | 1.0 | -0.3 | 0.2 | 0.2 | 0.3 | 0.6 | 1.1 | 1.3 | 1.0 | 1.6 | 1.4 |
| Other Insurance Companies | * | * | * | -0- | -0- | -0- | * | * | * | * | 0.2 | 0.1 | 0.1 | * | 0.2 | 0.3 | 0.2 | 0.2 | 0.2 | 0.1 |
| Finance Companies | 1.6 | 2.0 | 3.7 | -0- | 1.8 | 5.7 | 2.8 | 2.2 | 2.4 | -1.1 | -2.3 | -0.5 | 0.9 | 0.6 | 0.6 | 0.8 | 1.1 | 2.9 | 1.3 | -1.4 |
| REITS | — | — | — | — | — | 6.0 | 4.4 | 5.5 | 7.0 | 0.3 | -8.4 | -4.3 | -1.8 | -0.7 | -0.6 | -0.6 | -0.7 | -0.3 | -1.2 | -0.4 |

* Less than one-tenth of one percent
NA Not Available
Note: Annual data for 1981 is based on an average of the first three quarters of 1981 at seasonally adjusted annual rates
Source: Board of Governors of the Federal Reserve System, Flow of Funds Accounts, compiled by NAHB Economics Division.

SAVINGS FLOWS INTO THRIFT INSTITUTIONS, MONTHLY, 1978-1981
(In Millions of Dollars)

| | Net New Savings Received | | | | Net Savings Gain | | |
|---|---|---|---|---|---|---|---|
| | S&Ls | MSBs | Total | 4-Mth Moving Avg | S&Ls | MSBs | Total |
| 1978 | | | | | | | |
| Jan | $ 2,877 | $ -59 | $ 2,818 | $1,941 | $ 3,071 | $ 238 | $ 3,309 |
| Feb | 2,073 | 170 | 2,243 | 1,861 | 2,259 | 476 | 2,735 |
| Mar | 2,592 | 338 | 2,930 | 2,189 | 7,033 | 1,712 | 8,745 |
| Apr | 401 | -553 | -152 | 1,960 | 603 | -264 | 339 |
| May | 2,145 | 97 | 2,242 | 1,816 | 2,340 | 436 | 2,776 |
| Jun | 1,744 | -90 | 1,654 | 1,669 | 6,545 | 1,303 | 7,848 |
| Jul | 2,812 | 38 | 2,850 | 1,649 | 3,020 | 341 | 3,361 |
| Aug | 2,069 | -75 | 1,994 | 2,185 | 2,274 | 260 | 2,534 |
| Sep | 1,606 | -41 | 1,565 | 2,016 | 6,349 | 1,354 | 7,703 |
| Oct | 2,534 | 48 | 2,582 | 2,248 | 2,755 | 354 | 3,109 |
| Nov | 1,897 | -59 | 1,838 | 1,995 | 2,116 | 275 | 2,391 |
| Dec | 710 | -405 | 305 | 1,420 | 5,811 | 1,213 | 7,024 |
| Annual | $23,462 | $ -591 | $22,871 | N.A. | $44,175 | $ 7,698 | $51,873 |
| 1979 | | | | | | | |
| Jan | $ 4,377 | $ -118 | $ 4,259 | $2,094 | $ 4,661 | $ 218 | $ 4,879 |
| Feb | 2,580 | 342 | 2,922 | 2,179 | 2,834 | 682 | 3,516 |
| Mar | 3,146 | 463 | 3,609 | 2,621 | 8,210 | 1,971 | 10,181 |
| Apr | -1,490 | -1,192 | -2,682 | 2,027 | -1,130 | -818 | -1,948 |
| May | 1,627 | -341 | 1,286 | 1,284 | 2,007 | 61 | 2,068 |
| Jun | 1,469 | -635 | 834 | 762 | 6,751 | 1,009 | 7,760 |
| Jul | 1,455 | -733 | 722 | 40 | 1,985 | -337 | 1,648 |
| Aug | 717 | -504 | 213 | 764 | 1,183 | -92 | 1,091 |
| Sep | -198 | -1,072 | -1,270 | 125 | 4,779 | 487 | 5,266 |
| Oct | 1,314 | -1,421 | -107 | -111 | 1,843 | -1,028 | 815 |
| Nov | 732 | -765 | -33 | -299 | 1,315 | -325 | 990 |
| Dec | -700 | -986 | -1,686 | -774 | 4,460 | 830 | 5,290 |
| Annual | $15,029 | $-6,962 | $ 8,067 | N.A. | $38,898 | $ 2,658 | $41,556 |
| 1980 | | | | | | | |
| Jan | $ 1,167 | $-1,436 | $ -269 | $ -524 | $ 2,035 | $ -928 | $ 1,107 |
| Feb | 1,079 | -543 | 536 | -363 | 1,823 | -79 | 1,744 |
| Mar | -696 | -679 | -1,375 | -699 | 4,345 | 930 | 5,275 |
| Apr | -817 | -1,024 | -1,841 | -737 | 321 | -449 | -128 |
| May | 1,785 | 242 | 2,027 | -163 | 3,004 | 861 | 3,865 |
| Jun | -169 | -176 | -345 | -384 | 5,210 | 1,716 | 6,926 |
| Jul | 961 | 246 | 1,207 | 262 | 2,355 | 843 | 3,198 |
| Aug | 1,285 | 1 | 1,286 | 1,044 | 2,481 | 610 | 3,091 |
| Sep | 6 | -460 | -454 | 424 | 5,513 | 1,377 | 6,890 |
| Oct | 2,550 | -169 | 2,381 | 1,151 | 3,827 | 403 | 4,230 |
| Nov | 1,461 | -227 | 1,234 | 1,112 | 2,476 | 312 | 2,788 |
| Dec | 2,055 | -639 | 1,416 | 1,144 | 7,563 | 1,255 | 8,818 |
| Annual | $10,668 | $-4,864 | $ 5,804 | N.A. | $40,953 | $ 6,851 | $47,804 |

N.A. = Not Applicable

SAVINGS FLOWS INTO THRIFT INSTITUTIONS, MONTHLY, 1978-1981
(In Millions of Dollars)

| | Net New Savings Received | | | | Net Savings Gain | | |
|---|---|---|---|---|---|---|---|
| | S&Ls | MSBs | Total | 4-Mth Moving Avg | S&Ls | MSBs | Total |
| **1981** | | | | | | | |
| Jan | $ 599 | $ -979 | $ -380 | $ 1,163 | $ 2,060 | $ -365 | $ 1,695 |
| Feb | 879 | -385 | 494 | 691 | 2,276 | 296 | 2,572 |
| Mar | -2,137 | -757 | -2,894 | -341 | 3,694 | 1,224 | -4,918 |
| Apr | -4,638 | -2,025 | -6,663 | -2,361 | -2,857 | -1,234 | -4,091 |
| May | -70 | -676 | -746 | -2,452 | 1,696 | 148 | 1,844 |
| Jun | -5,739 | -1,387 | -7,126 | -4,357 | 317 | 542 | 859 |
| Jul | -5,538 | -1,935 | -7,473 | -5,502 | -3,491 | -1,133 | -4,624 |
| Aug | -3,290 | -1,542 | -4,832 | -5,044 | -1,343 | -672 | -2,015 |
| Sep | -3,799 | -1,679 | -5,478 | -6,227 | 2,172 | 319 | 2,491 |
| Oct | 1,601 | - 65 | 1,536 | -4,062 | 3,688 | 789 | 4,477 |
| Nov | -1,530 | -1,060 | -2,590 | -2,841 | 482 | -188 | 294 |
| Dec | -1,809 | -1,300 | -3,109 | -2,410 | 4,656 | 800 | 5,456 |
| Annual | $-25,471 | $-13,790 | $-39,261 | N.A. | $13,350 | $526 | $13,876 |
| **1982** | | | | | | | |
| Jan | | | | | | | |
| Feb | | | | | | | |
| Mar | | | | | | | |
| Apr | | | | | | | |
| May | | | | | | | |
| Jun | | | | | | | |
| Jul | | | | | | | |
| Aug | | | | | | | |
| Sep | | | | | | | |
| Oct | | | | | | | |
| Nov | | | | | | | |
| Dec | | | | | | | |
| Annual | | | | | | | |
| **1983** | | | | | | | |
| Jan | | | | | | | |
| Feb | | | | | | | |
| Mar | | | | | | | |
| Apr | | | | | | | |
| May | | | | | | | |
| Jun | | | | | | | |
| Jul | | | | | | | |
| Aug | | | | | | | |
| Sep | | | | | | | |
| Oct | | | | | | | |
| Nov | | | | | | | |
| Dec | | | | | | | |
| Annual | | | | | | | |

e = estimate

SOURCE: Federal Home Loan Bank Board, National Association of Mutual Saving Banks; Compilation by NAHB Economics Division.

UNEMPLOYMENT RATES: ALL WORKERS AND CONSTRUCTION WORKERS, 1971-1982
(Seasonally Adjusted Annual Rates)

| | Jan | Feb | Mar | Apr | May | Jun | Jul | Aug | Sep | Oct | Nov | Dec | Annual |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 1971 | | | | | | | | | | | | | |
| All Workers | 5.9% | 5.9% | 6.0% | 5.9% | 5.9% | 5.9% | 6.0% | 6.1% | 6.0% | 5.8% | 6.0% | 6.0% | 5.9% |
| Const. Workers | 11.5 | 11.1 | 11.1 | 10.1 | 9.9 | 10.5 | 9.5 | 9.6 | 9.4 | 9.8 | 10.3 | 10.9 | 10.4 |
| 1972 | | | | | | | | | | | | | |
| All Workers | 5.8% | 5.7% | 5.8% | 5.7% | 5.7% | 5.7% | 5.6% | 5.6% | 5.5% | 5.6% | 5.3% | 5.2% | 5.6% |
| Const. Workers | 10.3 | 10.8 | 10.3 | 10.5 | 10.9 | 9.7 | 10.4 | 11.3 | 8.9 | 10.1 | 10.1 | 9.7 | 10.3 |
| 1973 | | | | | | | | | | | | | |
| All Workers | 4.9% | 5.0% | 4.9% | 5.0% | 4.9% | 4.9% | 4.8% | 4.8% | 4.8% | 4.6% | 4.8% | 4.9% | 4.9% |
| Const. Workers | 9.4 | 9.3 | 8.9 | 9.1 | 8 | 8.0 | 9.1 | 8.4 | 9.0 | 8.9 | 9.0 | 8.4 | 8.9 |
| 1974 | | | | | | | | | | | | | |
| All Workers | 5.1% | 5.2% | 5.1% | 5.1% | 5.1% | 5.4% | 5.5% | 5.[illegible]% | 5.9% | 6.0% | 6.6% | 7.2% | 5.6% |
| Const. Workers | 9.5 | 8.5 | 8.6 | 9.9 | 9.5 | 9.9 | 10.2 | 1[illegible].9 | 11.6 | 12.1 | 13.6 | 15.3 | 10.7 |
| 1975 | | | | | | | | | | | | | |
| All Workers | 8.1% | 8.1% | 8.6% | 8.8% | 9.0% | 8.8% | 8.6% | 8.4% | 8.4% | 8.4% | 8.3% | 8.2% | 8.5% |
| Const. Workers | 15.7 | 16.3 | 17.8 | 19.2 | 21.5 | 19.8 | 19.5 | 19.1 | 18.5 | 17.8 | 17.4 | 16.8 | 18.0 |
| 1976 | | | | | | | | | | | | | |
| All Workers | 7.7% | 7.6% | 7.7% | 7.4% | 7.6% | 7.6% | 7.8% | 7.8% | 7.6% | 7.7% | 7.8% | 7.8% | 7.7% |
| Const. Workers | 15.5 | 15.4 | 15.7 | 15.6 | 14.7 | 16.3 | 16.8 | 16.6 | 15.7 | 14.7 | 15.4 | 14.3 | 15.5 |
| 1977 | | | | | | | | | | | | | |
| All Workers | 7.5% | 7.6% | 7.4% | 7.2% | 7.0% | 7.2% | 6.9% | 7.0% | 6.8% | 6.8% | 6.8% | 6.4% | 7.0% |
| Const. Workers | 14.8 | 14.7 | 13.9 | 12.5 | 13.4 | 12.6 | 12.0 | 11.5 | 10.5 | 11.8 | 11.4 | 10.8 | 12.7 |
| 1978 | | | | | | | | | | | | | |
| All Workers | 6.4% | 6.3% | 6.3% | 6.1% | 6.0% | 5.9% | 6.2% | 5.9% | 6.0% | 5.8% | 5.9% | 6.0% | 6.0% |
| Const. Workers | 11.6 | 11.1 | 11.0 | 9.8 | 9.7 | 9.6 | 9.8 | 9.2 | 10.9 | 11.2 | 10.8 | 12.3 | 10.6 |
| 1979 | | | | | | | | | | | | | |
| All Workers | 5.9% | 5.9% | 5.8% | 5.8% | 5.7% | 5.7% | 5.7% | 6.0% | 5.8% | 6.0% | 5.9% | 6.0% | 5.8% |
| Const. Workers | 10.9 | 11.4 | 10.2 | 10.4 | 9.6 | 9.6 | 9.7 | 9.2 | 9.2 | 10.0 | 10.5 | 11.2 | 10.3 |
| 1980 | | | | | | | | | | | | | |
| All Workers | 6.3% | 6.2% | 6.3% | 6.9% | 7.5% | 7.5% | 7.8% | 7.7% | 7.5% | 7.5% | 7.5% | 7.3% | 7.1% |
| Const. Workers | 11.7 | 11.3 | 13.1 | 14.6 | 16.1 | 15.2 | 15.8 | 16.7 | 15.8 | 14.[illegible] | 14.5 | 13.8 | 14.1 |
| 1981 | | | | | | | | | | | | | |
| All Workers | 7.4% | 7.4% | 7.3% | 7.3% | 7.5% | 7.4% | 7.2% | 7.3% | 7.6% | 8.0% | 8.3% | 8.8% | 7.6% |
| Const. Workers | 13.7 | 13.7 | 14.7 | 14.5 | 15.7 | 16.1 | 15.2 | 16.2 | 16.3 | 17.6 | 17.8 | 18.1 | 15.6 |
| 1982 | | | | | | | | | | | | | |
| All Workers | 8.5% | | | | | | | | | | | | |
| Const. Workers | 18.7 | | | | | | | | | | | | |
| 1983 | | | | | | | | | | | | | |
| All Workers | | | | | | | | | | | | | |
| Const. Workers | | | | | | | | | | | | | |

Source: Bureau of Labor Statistics; compilation by NAHB Economics Division.

NUMBER OF UNEMPLOYED AMONG ALL WORKERS AND CONSTRUCTION WORKERS, 1971-1982
(Seasonally Adjusted Annual Rates in Thousands)

| | Jan | Feb | Mar | Apr | May | Jun | Jul | Aug | Sep | Oct | Nov | Dec | Annual |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 1971 | | | | | | | | | | | | | |
| All Workers | 4,986 | 4,903 | 4,987 | 4,959 | 4,996 | 4,949 | 5,035 | 5,134 | 5,042 | 4,954 | 5,161 | 5,154 | 5,016 |
| Const. Workers | 457 | 436 | 443 | 402 | 398 | 429 | 395 | 404 | 379 | 411 | 433 | 472 | 428 |
| 1972 | | | | | | | | | | | | | |
| All Workers | 5,019 | 4,928 | 5,038 | 4,959 | 4,922 | 4,923 | 4,913 | 4,939 | 4,849 | 4,875 | 4,602 | 4,543 | 4,882 |
| Const. Workers | 440 | 462 | 454 | 461 | 478 | 419 | 448 | 497 | 385 | 445 | 447 | 429 | 450 |
| 1973 | | | | | | | | | | | | | |
| All Workers | 4,326 | 4,452 | 4,394 | 4,459 | 4,329 | 4,363 | 4,305 | 4,305 | 4,350 | 4,144 | 4,396 | 4,489 | 4,365 |
| Const. Workers | 420 | 416 | 401 | 414 | 403 | 377 | 429 | 384 | 412 | 411 | 413 | 386 | 407 |
| 1974 | | | | | | | | | | | | | |
| All Workers | 4,644 | 4,731 | 4,634 | 4,618 | 4,705 | 4,927 | 5,063 | 5,022 | 5,437 | 5,523 | 6,140 | 6,636 | 5,156 |
| Const. Workers | 452 | 397 | 400 | 458 | 436 | 447 | 445 | 487 | 528 | 565 | 615 | 689 | 486 |
| 1975 | | | | | | | | | | | | | |
| All Workers | 7,501 | 7,520 | 7,978 | 8,210 | 8,433 | 8,220 | 8,127 | 7,928 | 7,923 | 7,897 | 7,794 | 7,744 | 7,[illegible]29 |
| Const. Workers | 691 | 718 | 787 | 850 | 969 | 893 | 879 | 871 | 844 | 813 | 779 | 750 | 807 |
| 1976 | | | | | | | | | | | | | |
| All Workers | 7,534 | 7,326 | 7,230 | 7,330 | 7,053 | 7,053 | 7,322 | 7,490 | 7,518 | 7,380 | 7,430 | 7,620 | 7,406 |
| Const. Workers | 681 | 681 | 694 | 683 | 646 | 729 | 755 | 764 | 712 | 668 | 685 | 663 | 694 |
| 1977 | | | | | | | | | | | | | |
| All Workers | 7,280 | 7,443 | 7,307 | 7,059 | 6,911 | 7,134 | 6,829 | 6,925 | 6,751 | 6,763 | 6,815 | 6,386 | 6,991 |
| Const. Workers | 675 | 674 | 645 | 581 | 630 | 598 | 567 | 535 | 477 | 551 | 546 | 513 | 593 |
| 1978 | | | | | | | | | | | | | |
| All Workers | 6,488 | 6,304 | 6,304 | 6,188 | 6,161 | 5,995 | 6,314 | 6,077 | 6,121 | 5,947 | 6,074 | 6,250 | 6,202 |
| Const. Workers | 557 | 532 | 535 | 491 | 480 | 479 | 495 | 468 | 564 | 568 | 541 | 628 | 530 |
| 1979 | | | | | | | | | | | | | |
| All Workers | 6,106 | 6,148 | 6,108 | 6,076 | 5,913 | 5,913 | 5,985 | 6,298 | 6,173 | 6,293 | 6,255 | 6,409 | 6,137 |
| Const. Workers | 566 | 594 | 532 | 537 | 492 | 407 | 507 | 479 | 483 | 541 | 572 | 614 | 541 |
| 1980 | | | | | | | | | | | | | |
| All Workers | 6,660 | 6,635 | 6,714 | 7,370 | 8,059 | 8,024 | 8,330 | 8,239 | 8,024 | 8,109 | 8,066 | 7,899 | 7,637 |
| Const. Workers | 630 | 601 | 697 | 759 | 869 | 800 | 812 | 867 | 814 | 744 | 767 | 711 | 740 |
| 1981 | | | | | | | | | | | | | |
| All Workers | 8,022 | 7,965 | 7,958 | 7,899 | 8,248 | 8,004 | 7,824 | 7,978 | 8,236 | 8,669 | 9,100 | 9,571 | 8,273 |
| Const. Workers | 712 | 712 | 759 | 758 | 823 | 826 | 796 | 853 | 852 | 916 | 916 | 933 | 809 |
| 1982 | | | | | | | | | | | | | |
| All Workers | 9,298 | | | | | | | | | | | | |
| Const. Workers | 946 | | | | | | | | | | | | |
| 1983 | | | | | | | | | | | | | |
| All Workers | | | | | | | | | | | | | |
| Const. Workers | | | | | | | | | | | | | |

Source: Bureau of Labor Statistics, Compilation by NAHB Economics Division.

FAILURE RATES IN THE CONSTRUCTION INDUSTRY, 1974-80
(in thousands of dollars)

NUMBER OF FAILURES

| | General Building Contractors | Building Sub-contractors | Other Contractors | Total Construction |
|---|---|---|---|---|
| 1974 | 714 | 1,023 | 103 | 1,840 |
| 1975 | 942 | 1,202 | 118 | 2,262 |
| 1976 | 716 | 940 | 114 | 1,770 |
| 1977 | 608 | 764 | 91 | 1,463 |
| 1978 | 508 | 631 | 65 | 1,204 |
| 1979 | 631 | 687 | 60 | 1,378 |
| 1980 | 1,071 | 1,164 | 120 | 2,355 |
| Percent Changes | | | | |
| 1974/75 | 31.9% | 17.5% | 14.6% | 22.9% |
| 1975/76 | -24.0 | -21.8 | -3.4 | -21.8 |
| 1976/77 | -15.1 | -18.7 | -20.2 | -17.3 |
| 1977/78 | -16.4 | -17.4 | -28.6 | -17.7 |
| 1978/79 | 24.2 | 8.9 | -7.7 | 14.5 |
| 1979/80 | 69.7 | 69.4 | 100.0 | 70.9 |

DOLLAR LIABILITIES

| | General Building Contractors | Building Sub-contractors | Other Contractors | Total Construction |
|---|---|---|---|---|
| 1974 | $367,643 | $126,126 | $32,829 | $526,598 |
| 1975 | 461,987 | 142,039 | 36,819 | 640,845 |
| 1976 | 261,613 | 137,049 | 30,075 | 428,737 |
| 1977 | 168,926 | 209,126 | 42,168 | 420,220 |
| 1978 | 145,643 | 140,359 | 42,376 | 328,378 |
| 1979 | 147,287 | 102,511 | 41,525 | 291,323 |
| 1980 | 334,908 | 333,333 | 83,868 | 752,109 |
| Percent Changes | | | | |
| 1974/75 | 25.7% | 12.6% | 12.2% | 21.7% |
| 1975/76 | -43.4 | -3.5 | -18.3 | -33.1 |
| 1976/77 | -35.4 | 52.6 | 40.2 | -2.0 |
| 1977/78 | -13.8 | -32.9 | 0.5 | -21.9 |
| 1978/79 | 1.1 | -27.0 | -2.0 | -11.3 |
| 1979/80 | 127.4 | 225.2 | 102.0 | 158.2 |

Source: Dun & Bradstreet, Monthly Failures; compiled by NAHB Economics Division

FAILURE RATES IN THE CONSTRUCTION INDUSTRY, MONTHLY, 1979-81
(in thousands of dollars)

| | Number of Failures | | | | Dollar Liabilities | | | |
|---|---|---|---|---|---|---|---|---|
| | General Building Contractors | Building Sub-contractors | Other Contractors | Total Construction | General Building Contractors | Building Sub-contractors | Other Contractors | Total Construction |
| 1979 | | | | | | | | |
| Jan. | 63 | 58 | 6 | 127 | $15,065 | $ 6,980 | $ 2,608 | $24,653 |
| Feb. | 45 | 54 | 5 | 104 | 7,448 | 9,788 | 2,146 | 19,382 |
| Mar. | 52 | 71 | 6 | 129 | 14,460 | 10,544 | 786 | 25,790 |
| Apr. | 57 | 70 | 5 | 132 | 10,271 | 7,518 | 7,767 | 25,556 |
| May. | 55 | 63 | 7 | 125 | 13,837 | 15,502 | 5,371 | 34,710 |
| Jun. | 54 | 53 | 6 | 113 | 11,830 | 9,676 | 3,292 | 24,798 |
| Jul. | 36 | 53 | 4 | 93 | 7,223 | 7,515 | 708 | 15,446 |
| Aug. | 66 | 73 | 3 | 142 | 20,608 | 10,669 | 1,610 | 32,887 |
| Sep. | 50 | 53 | 4 | 107 | 10,559 | 6,842 | 768 | 18,169 |
| Oct. | 61 | 66 | 6 | 133 | 17,799 | 8,039 | 15,564 | 41,402 |
| Nov. | 45 | 41 | 5 | 91 | 6,662 | 4,748 | 211 | 11,621 |
| Dec. | 47 | 32 | 3 | 82 | 11,525 | 4,690 | 694 | 16,909 |
| 1980 | | | | | | | | |
| Jan. | 61 | 56 | 5 | 122 | $15,934 | $ 6,603 | $ 7,883 | $30,420 |
| Feb. | 70 | 68 | 11 | 149 | 21,886 | 10,061 | 5,223 | 37,170 |
| Mar. | 97 | 89 | 6 | 192 | 33,318 | 12,845 | 1,647 | 47,810 |
| Apr. | 102 | 101 | 11 | 214 | 35,677 | 93,679 | 4,669 | 134,025 |
| May. | 89 | 103 | 10 | 202 | 32,267 | 22,214 | 29,924 | 84,405 |
| Jun. | 99 | 107 | 4 | 210 | 33,186 | 95,776 | 1,729 | 130,691 |
| Jul. | 100 | 96 | 19 | 215 | 29,006 | 12,306 | 7,767 | 49,079 |
| Aug. | 105 | 104 | 12 | 221 | 42,639 | 15,368 | 2,671 | 60,678 |
| Sep. | 78 | 102 | 10 | 190 | 23,357 | 13,710 | 4,251 | 41,318 |
| Oct. | 108 | 161 | 13 | 282 | 30,218 | 25,352 | 4,401 | 59,971 |
| Nov. | 82 | 77 | 9 | 168 | 14,203 | 13,282 | 2,337 | 29,822 |
| Dec. | 80 | 100 | 10 | 190 | 23,217 | 12,137 | 11,366 | 46,720 |
| 1981 | | | | | | | | |
| Jan. | 107 | 108 | 14 | 229 | $43,304 | $17,527 | $ 8,199 | $69,030 |
| Feb. | 78 | 132 | 18 | 228 | 26,963 | 22,095 | 5,343 | 54,401 |
| Mar | 97 | 118 | 13 | 228 | 20,855 | 27,488 | 3,510 | 51,853 |
| Apr | 132 | 180 | 15 | 327 | 31,292 | 24,790 | 2,719 | 58,801 |
| May | 153 | 171 | 11 | 355 | 38,272 | 24,721 | 1,179 | 63,722 |

Source: Dun & Bradstreet, Monthly Failures; compiled by NAHB Economics Division

February 23, 1982

HOUSING STARTS AND HOUSING-RELATED ECONOMIC INDICATORS, 1981 ACTUAL AND 1982 FORECASTED, USING TWO SCENARIOS

Scenario I

| | Forecasted Data | | | | Annual Data | |
|---|---|---|---|---|---|---|
| | 82-Q1 | 82-Q2 | 82-Q3 | 82-Q4 | 1981 | 1982 |
| Interest Rates (%) | | | | | | |
| 3 Month T-Bills | 13.80% | 14.20% | 12.20% | 10.50% | 14.08% | 12.68% |
| Prime Rate | 16.50 | 17.50 | 15.00 | 13.00 | 18.87 | 15.50 |
| AAA Bonds | 15.40 | 15.50 | 14.50 | 13.00 | 14.17 | 14.60 |
| Personal Income (B/$) | $ 2,531 | $ 2,579 | $ 2,631 | $ 2,691 | $ 2,404 | $ 2,608 |
| Total Population (000) | 230,809 | 231,342 | 231,883 | 232,425 | 223,438 | 231,615 |
| Consumer Price Index (1967=100) | 284.3 | 289.0 | 293.6 | 298.1 | 272.3 | 291.3 |
| Unemployment Rate (%) | 8.8% | 9.2% | 9.1% | 8.9% | 7.6% | 9.0% |
| FHLBB Advances (M/$) | $ -200 | $ -100 | $ -400 | $ -200 | $15,682 | $ -900 |
| FNMA Purchases (M/$) | $ 800 | $ 400 | $ 600 | $ 800 | $ 6,111 | $ 2,600 |
| HUD Subsidized Units | 6,100 | 5,000 | 9,200 | 1,300 | 76,256 | 21,600 |
| Housing Starts-SAAR (000) | | | | | | |
| Total | 859.7 | 998.6 | 1,128.3 | 1,258.2 | 1,085.3 | 1,073.7 |
| Single Family | 514.1 | 626.1 | 770.0 | 847.5 | 706.0 | 699.9 |
| Multifamily | 345.6 | 372.5 | 358.3 | 410.7 | 379.3 | 373.8 |
| 2-4 Units | 100.3 | 86.5 | 84.6 | 89.1 | 91.2 | 89.4 |
| 5 + Units | 245.3 | 286.0 | 273.7 | 321.6 | 288.1 | 284.4 |
| Housing Starts-Actual (000) | | | | | | |
| Total | 157.3 | 289.6 | 312.9 | 313.9 | 1,085.3 | 1,073.7 |
| Single Family | 91.2 | 189.0 | 217.8 | 201.9 | 706.0 | 699.9 |
| Multifamily | 66.1 | 100.6 | 95.1 | 112.0 | 379.3 | 373.8 |
| 2-4 Units | 18.8 | 23.6 | 23.7 | 23.3 | 91.2 | 89.4 |
| 5 + Units | 47.3 | 77.0 | 71.4 | 88.7 | 288.1 | 284.4 |
| Mobile Home Shipments (000) | | | | | | |
| Actual | 37 | 50 | 53 | 44 | 241 | 184 |
| SAAR | 189 | 180 | 183 | 185 | 241 | 184 |
| Effective Mortgage Rate (%) | 16.23% | 16.71% | 16.83% | 16.39% | 14.74% | 16.54% |
| Median New House Price ($) | $69,030 | $69,839 | $69,365 | $71,952 | $68,800 | $70,047 |

Source: Various governmental agencies; NAHB Forecasting Service.

February 23, 1982

HOUSING STARTS AND HOUSING-RELATED ECONOMIC INDICATORS, 1981 ACTUAL AND 1982 FORECASTED, USING TWO SCENARIOS

Scenario II

| | Forecasted Data | | | | Annual Data | |
|---|---|---|---|---|---|---|
| | 82-Q1 | 82-Q2 | 82-Q3 | 82-Q4 | 1981 | 1982 |
| Interest Rates (%) | | | | | | |
| 3 Month T-Bills | 13.80% | 14.20% | 13.80% | 14.20% | 14.08% | 14.00% |
| Prime Rate | 16.50 | 18.00 | 16.50 | 20.00 | 18.87 | 17.75 |
| AAA Bonds | 15.60 | 15.70 | 15.10 | 15.60 | 14.17 | 15.50 |
| Personal Income (B/$) | $ 2,531 | $ 2,579 | $ 2,630 | $ 2,683 | $ 2,404 | $ 2,606 |
| Total Population (000) | 230,809 | 231,342 | 231,883 | 232,425 | 223,438 | 231,615 |
| Consumer Price Index (1967=100) | 284.3 | 289.0 | 293.6 | 298.4 | 272.3 | 291.3 |
| Unemployment Rate (%) | 8.8% | 9.2% | 9.5% | 9.6% | 7.6% | 9.3% |
| FHLBB Advances (M/$) | $ -200 | $ -400 | $ -200 | $ -300 | $15,682 | $-1,100 |
| FNMA Purchases (M/$) | $ 800 | $ 300 | $ 600 | $ 200 | $ 6,111 | $ 1,900 |
| HUD Subsidized Units | 6,100 | 5,000 | 9,200 | 1,300 | 76,256 | 21,600 |
| Housing Starts-SAAR (000) | | | | | | |
| Total | 859.8 | 969.0 | 1,015.8 | 1,054.1 | 1,085.3 | 983.0 |
| Single Family | 514.2 | 601.2 | 677.9 | 698.3 | 706.0 | 630.9 |
| Multifamily | 345.6 | 367.8 | 337.9 | 355.8 | 379.3 | 352.1 |
| 2-4 Units | 100.3 | 86.1 | 83.4 | 86.9 | 91.2 | 88.3 |
| 5 + Units | 245.3 | 281.7 | 254.5 | 268.9 | 288.1 | 263.8 |
| Housing Starts-Actual (000) | | | | | | |
| Total | 157.3 | 280.9 | 281.5 | 263.3 | 1,085.3 | 983.0 |
| Single Family | 91.2 | 181.5 | 191.8 | 166.4 | 706.0 | 630.9 |
| Multifamily | 66.1 | 99.4 | 89.7 | 96.9 | 379.3 | 352.1 |
| 2-4 Units | 18.8 | 23.5 | 23.3 | 22.7 | 91.2 | 88.3 |
| 5 + Units | 47.3 | 75.9 | 66.4 | 74.2 | 288.1 | 263.8 |
| Mobile Home Shipments (000) | | | | | | |
| Actual | 37 | 50 | 51 | 41 | 241 | 179 |
| SAAR | 189 | 180 | 177 | 174 | 241 | 179 |
| Effective Mortgage Rate (%) | 16.23% | 16.80% | 17.11% | 17.13% | 14.74% | 16.82% |
| Median New House Price ($) | $69,031 | $69,640 | $68,697 | $70,006 | $68,800 | $69,344 |

Source: Various governmental agencies; NAHB Forecasting Service.

The CHAIRMAN. Thank you very much. And again, I have read through your testimony and all the charts and the problems of your industry which will be valuable information in the printed record.

CREDIT CONTROLS

First of all, let me say, Mr. Schechter, that you and I have discussed credit controls before and we disagree, so I doubt if again today you could convince me or I could convince you. I certainly believe in your sincerity in your advocacy of those positions and maybe if we just got back to monetary policy—well, let me ask one question about credit controls.

Assuming that you're correct that they did have an effect in 1980, then is it an assumption from what happened after they were taken off that it would be necessary to have permanent credit controls to have them work?

Mr. SCHECHTER. No, I don't think it has to be permanent. At a time, though, when the economy gets a shock, which happens once in a while—the OPEC effect certainly was an example—or there are mistakes in terms of money supply growth, people can't control those factors, especially since we have a large Eurodollar market and any large firm can pick up a phone and talk to Germany and say, "Transfer some money to our account here." So it happens very quickly. So at that time, when that happens, or we have a big upsurge in corporate takeovers which lines up a total, like during 1981, of about $81 billion of commitments. Not all of it was used. We had some big ones like the Conoco takeover by Du Pont, $3 billion; United States Steel bought Marathon with $3 billion in credit. So there are times I think when we would want to have credit controls applied even sometimes to a specific—say no takeovers this year, fellows, because the situation is tight. I think it could help a great deal.

It doesn't have to be permanent. It doesn't have to be, by any means, across the economy.

The CHAIRMAN. Let me return to operating techniques of the Fed, a discussion that I had earlier with members of the administration in which I certainly indicated—all of you were here—my lack of understanding about some of those operating procedures and contemporaneous reserve accounting and possibly penalty discount rate, approved definitions of money, and we discussed at great length the stopping of weekly reporting and calculating monetary aggregates.

First of all, Mr. Schechter, how do you feel about that discussion, having heard it? You did not have an opportunity to reply at that time about these mechanical operating procedures.

Mr. SCHECHTER. I agree that the Fed cannot get an accurate count every week of what actually happened. At the same time, I know this mania has sprung up of watching the weekly numbers. It's the way the market is going to behave. I don't know how you get around it by telling the Fed don't publish something, because as has been discussed——

The CHAIRMAN. I was so hoping you would be practical and on my side and say it's ridiculous and give me a different analysis other than it's ridiculous but we've got to keep doing it.

Mr. SCHECHTER. Let me suggest, as Mr. Sprinkel did, using the monetary base, everybody would soon figure out the relationship between the monetary base and what is happening between the total supply, and you would get the same effect.

The CHAIRMAN. Mr. Sumichrast?

Mr. SUMICHRAST. I think we should dump it. It doesn't make any sense. It never made any sense to me. How could that possibly justify changing a portfolio or making an investment? I think either cut it out entirely weekly or go to monthly reporting or seasonal adjustment. I know my friends tell me seasonal adjustment is horrible. It just can't be done in any good way. Publishing it monthly or publishing it on a 6-month moving average of some sort would be better. We prepared some charts and when you look at these it's incredible. It zig-zags like crazy, goes up and down, and as I say, the economy is still here. One week has passed by. What has changed? I don't understand it really. It never made any sense to me.

Mr. SCHECHTER. I think though, this has a much more important point; that is, there is monetary policy being conducted on the basis of those figures and it's not just—although they say, well, wait for the long-term adjustment, actually the open market operations which are carried on every day are changed in accordance with those figures within the targets. There are changes from day to day and people watching not just the numbers, who can tell when the Fed has intervened to buy or sell securities in the market. And even when on that basis the conclusion is reached the Fed is tightening, and therefore everybody goes out and anticipates and borrows or tries to borrow.

My point is, I think we really need to start using other tools for monetary policy besides this one.

Mr. SUMICHRAST. It's a lot of speculation. It's like in housing, the same thing. Do you think I like the idea of having a piece of junk sitting in Georgetown for $180,000 that would be sold for $75,000 or so in California? It's the same thing. Everybody is looking for all kinds of gimmicks on how to make money and that's probably the institutional setup. They start to dream up how to make a little more on what happened Friday afternoon. I think it's wrong. I think it's entirely wrong to have it, but it's the kind of situation we're in. I don't know how you can get out of that sort of thing. We got out of it in housing. Housing is in deflation right now. It's in deflation for the first time in 50 years—deflation in prices of homes—and the reason is we have so much invested in it. I guess the financial market will have to go through the same sort of cycle before they realize there is no virtue or money to be made on that.

PENALTY DISCOUNT

The CHAIRMAN. Mr. McKinney, what about penalty discount?

Mr. MCKINNEY. I think that clearly a discount rate that is more sensitive to market interest rates and doesn't permit as wide a spread to develop between market interest rates and the discount

rate would be more productive because the incentive to find the cheapest source of funds would not be focused so strongly on the discount window. To move to a penalty discount rate as opposed to keeping the discount rate shortly below other interest rates would involve an awful lot of mechanical troubles and difficulties and I think it would probably lead to explosive changes in interest rates unless the Federal Reserve changed its operating policies considerably.

I think it's a good case for holding it much closer to market rates than it is now held, but it would change our system of money control markedly to let it move above and keep it there.

The CHAIRMAN. Mr. Schechter, how do you feel about the penalty discount?

Mr. SCHECHTER. I would like to see something that does keep some relation to the rates of interest so it doesn't become a means of using the discount window simply to make a buck and at the same time defeating whatever monetary policy is in effect.

Mr. SUMICHRAST. I would support that.

The CHAIRMAN. Mr. Schechter, let me get back to what we started to discuss, and certainly Mr. Sumichrast has pointed out there's deflation right now in the housing industry. That's an understatement today. And I have long been involved in housing because of being a mayor and the problems associated with it, and I don't know of anything that troubles me more unless it's the automobile industry. But housing is even more basic to the way people live than an automobile.

And when I became chairman of this committee the prime rate was 21.5 percent. I had been chairman a couple of days and people wanted to know why it hadn't gone down. And it has gone down somewhat and I never thought I would live long enough to say that 12 percent prime would be just fantastic, if we could get it down to that, and having left a 5-percent conventional mortgage when I moved here from Salt Lake City and complaining about a 9-percent mortgage on my home, and now that's almost like giving money away.

So I want you all to understand I understand the problem very well, not only from my public service but as an individual, and I don't know how my kids are ever going to buy a house with the current conditions.

Mr. SUMICHRAST. You'll have to buy one for them. That's what you have to do.

The CHAIRMAN. On my Senate salary, when I'm paying for one in Salt Lake City and one here? They can live with me but I'm not buying one for them.

In any event, what you say is true. OPEC has been part of the inflationary problem; the housing market has. There are a lot of factors that make up these high interest rates and yet with deflation in a lot of the economy now, interest rates are still high. So I've puzzled over that for the last year and I've studied and listened to everything I can and economists from all different points of view trying to figure out why. You're supposed to have interest rates come down when there's deflation, particularly in basic industries like housing and automobiles and so on, and the normal rules of the economy are not being followed.

So I can only come to one conclusion: that the major reason that interest rates are staying high, particularly long-term interest rates, is because of the fact that these long-term money market managers are not particularly concerned—and that's an overstatement—about 1982's deficit. They are concerned, but what they are more concerned about is not what we talk in outyears when we talk about the 1983 and 1984 budget, but they are looking at 1988, 1989, 1990, and 1991. They are not looking at Ronald Reagan or this Congress or Republicans or Democrats, liberals or conservatives. All they can see, regardless of who is here, is we have been building such obligations for the future with Federal spending that they are looking far, far beyond what any discussion is in the press or anything else in those outyears, and they are not going to be stupid enough to be caught, as many times they have been, borrowing short and lending long.

My point is, even if we somehow eased upon the money supply right now, as many people want to, if we removed the third year of the tax cut as a basic suggestion and cut the one for July in half and cut military spending by $20 to $30 billion, which would only have about a $5 billion impact on outlays on this year's budget because that's longer outyear spending, at least it's my opinion everybody would be shocked and say, "Hey, nothing happened. We've still got 16 or 17 percent prime. We balanced the budget. What's wrong with that theory?"

I think what is wrong with that theory is because they are still looking and saying, "Those guys in Congress haven't done anything about 1990."

ENTITLEMENT PROGRAMS

So in your testimony—I can agree with a lot of it, but there's practically no mention of fiscal policy in your testimony at all, and it seems to me if we don't address those outyears far beyond the immediate discussion, I don't expect that we're going to have lower interest rates other than cyclical ups and downs a little bit, and that means to me that we simply have to address the problem of entitlements because I don't have to be an economist to get out my calculator and look at the budget as a member of the Appropriations Committee and see that in round numbers we've got about 53 percent of the budget that is increasing at about 16 percent compounded per year and another 47 percent of the budget or so that's been decreased at about 8 percent. Yet we have proposals from the administration that basically say, cut the same piece of pie over and over and over again, which you can't do. I could eliminate NASA in my Appropriations Subcommittee and save $6 billion a year and have no space program at all, and that's not an insignificant amount of money, but the dollars in these automatic indexed programs are so fantastic.

I've got a friend who's a retired brigadier general who makes more now that he's retired than if he had stayed on duty. And those kind of things—in fact, the former Speaker of the House of Massachusetts, at the time he died, was making $90,000 a year from his Federal civil service retirement, $30,000 more than a current Congressman.

So you look at that situation, particularly when the vast majority of the people in this country and in your unions don't have automatically indexed programs at all and Federal employees that are working don't have automatically indexed programs, and yet to put it bluntly, we are gutless to attack that situation and say that we've got to do something about that longer term situation.

That's a long speech, but I'd like all of your reactions to that. And when I kept asking the question, can monetary policy be effective until we do something about that, they said, yes. I don't agree with that. I think all of these things we talk about are toying with the problem until we convince those money market managers that those trendlines are going to level off in those outyears a decade down the road and start downward, and until we do, I think we are going to have continued high inflation rates regardless of what happens with OPEC, and I think we are going to have continued high interest rates unless we have the intestinal fortitude to address that problem. And so far, the administration has not and certainly Congress has been unwilling to address those automatically indexed programs.

Mr. SCHECHTER. Mr. Chairman, I think you're really getting into a broader subject, and I don't mean just broader than monetary policy. The subject you're getting into is incomes distribution, after taxes perhaps, and I would say the brigadier general or former Speaker of the House probably had rather high retirement income. That is not true of the great majority of people on social security or on Federal civil service retirement.

The CHAIRMAN. Well, you're correct. They certainly don't have those kinds of incomes. But to say that a social security recipient, who is probably the one hurt the most by inflation, that they can have pensions regardless of what level they are—not the $90,000 like the Speaker of the House—but accelerated more rapidly than inflation when your workers and the Federal workers and other retirees on private pension plans that have not even come close to keeping up with inflation—and those are big dollars there.

What I'm suggesting, as an example, is with civil service pensions, social security, things of that nature, that we put those back under the control of Congress. Like Federal employees this year got 4.8 percent. We decided that's what we could afford. And maybe you have a 10-percent inflation rate and you tell all the retired people you're still going to get an increase but all we can afford is 7 percent, and that difference is 3 percent in those outyears which is a lot of money, and if that signal is sent and it brought down interest rates so that people can buy homes—my kids and others—I think that's a valuable step to take.

Mr. SCHECHTER. But we're not talking other people with increased incomes, maybe even greater increases, that we want them to, for the good of the country, hold their income increases down—private professionals let's say.

The CHAIRMAN. You're talking about two different things. I'm certainly not advocating that any members of your union, any of your working people, have Government limitations on their income. That's private sector and whatever you can negotiate in your contracts, that's fine with me. That's your job. And whatever

profession—it doesn't matter what profession you're in. I'm talking about taxpayers' dollars that create a deficit.

PROGRESSIVE INCOME TAX SYSTEM

Mr. SCHECHTER. But let me make two points. We did have something called the progressive income tax system, and what happened in 1981 took away taxpayer dollars. In other words, it took away revenue and increased other people's tax payments over the long run. So what we are dealing with here—that's why I said it's a broader matter of incomes distribution—now the people who went to work for the Government or were on social security have the notion of a contract, if you will, based on what the entitlements were at that time. So in a way——

The CHAIRMAN. There was never any contract in social security that guaranteed people automatic increases. There is a contract to guarantee them the pension and the benefits set out.

Mr. SCHECHTER. Plus a cost of living. But my point——

The CHAIRMAN. Not plus the cost of living. That was only added about 10 or 12 years ago.

Mr. SCHECHTER. All right. The people who've worked since then expected it. But forgetting about that for the moment, I think the reason we put in a progressive income tax is a matter of equity and what we have created here between the monetary policy and reduction of taxes is really, as I indicated, a two-tier system, because the people who have the high incomes also get the greatest advantage of the high interest rates. Their income goes up and at the same time they can then go out and buy what they want and bid up prices. So they have a sort of thing going for them and the rest of us pay, and I think if we overlook that—and we can even see what happened to the income distribution.

Since 1967, up to then it had been going more toward, let's say, equality, if you want to call it that, but since then the share going to the upper 20 percent—to the families who are in the upper 20 percent of the income distribution went up from 40.4 percent to 41.6 percent. Now that's about $20 billion that shifted, roughly, in round numbers. They have discretionary income more than ever and things have gone up. I put some figures in my statement on the percentage of total personal income which went to five categories of expenditures, including things like boats and airplanes and airline travel and other things which are really for high-income folks. That has gone from 2.5 percent in 1947 of total personal income to 4 percent in 1981. So what we are doing is the more we cut high income taxes particularly—and that's what happened last year—the more we are creating the machine for inflation in the economy and more high interest rates.

The CHAIRMAN. I've got to go vote. I would like a quick comment from each of you, but I do want to hurriedly say for Henry—and I consider him a good friend of mine and we have talked over this table for many years—the other side of that coin is that, first of all, we still have a very progressive income tax. Second, there is no real overall tax cut. There was a reduction in the increase last year. The Federal revenues are still higher. Third, I would say, to give you a situation on this spending by these people who are

rich—I don't happen to be one of them that can afford a half million dollar condominium in Park City, Utah, right now, but if you go out there, the homebuilding industry is dead. Most of the construction activity is in the resort area where all these rich people from Texas or wherever can come in, but I guarantee you that the carpenters and the plumbers don't care who's buying that. The people building those things for rich people at least have a job and they are tickled to death they are working. They don't care if it's a single-family dwelling or not, as long as they are working. So I suggest the other side of the coin of what you're saying is there is some benefit from people who have money to buy boats and condominiums that produce jobs for people who otherwise would not have them.

Mr. McKINNEY. Mr. Chairman, would you spare 1 minute?

The CHAIRMAN. I'm going to give each of you a chance quickly because I've got to go vote and I will not be coming back. We had 21 votes yesterday and I'd just be wasting your time to run back and forth.

Mr. McKINNEY. One point I would point out is that distribution of income has very little directly to do with inflation. Inflation is what we're talking about. Inflation is what the Nation and the present administration and most of the people in Congress should get rid of. Inflation has to do with the Nation as a whole trying to spend more than it produces, and the biggest swinging factor in that is the Congress. The size of the deficit is an important factor in this. As detailed in my testimony, 43 percent of the inflation since 1960 can be accounted for by the Federal deficit alone.

Now the solution to inflation will not be reached until the Nation has delivered on some of those promises that were made to reduce inflation.

The CHAIRMAN. Would you quickly agree or not agree that those out-year deficits are a driving force in the long-term interest rates and the problems that Mr. Sumichrast's organization is having?

Mr. McKINNEY. I agree fully.

Mr. SUMICHRAST. There are three issues and I'll take only 30 seconds. One issue is the differentiation of prices of housing. I would like to include this material into the record which shows this.

The CHAIRMAN. We would be happy to include it.

[The information follows:]

LAND REVIEW

VOLUME 2, NO. 3 MARCH 1982

Dr. Marika E. Sumichrast, Vice President Development & Editor

Land Cost Market Reporting Service

# Prices of Real Estate Decline

There is mounting evidence showing a decline in real estate prices, the first such evidence in 50 years. Both home and land prices have turned down. This, of course, is not true of all real estate everywhere. But, the information available offers sufficient proof of some degree of deflation. One can no longer assume that real estate holdings can be sold for more than paid for one or two years ago.

The documentation comes from different sources and is to be evaluated separately. Some data show a straight decline while other data show only a lesser rate of increase than in the past. The data covers existing homes, new homes and land. The analysis reveals a big change from past years of rapid appreciation.

## Summary of price changes

| Cost price data | Percent change between QIV-80 to QIV-81 | QIII-81 to QIV-81 |
|---|---|---|
| Homes in 32 cities[1] | +10.5% | −1.2% |
| New homes[2] | + 4.6 | −0.4 |
| New homes FHA[3] | + 5.1** | +3.5 |
| New homes—index[2] | + 8.0 | +0.9* |
| Existing homes[4] | + 4.7 | −2.9 |
| Existing homes FHA[3] | + 1.0** | −0.5 |
| Cost per SF, finished lots[5] | + 5.7 | −1.8* |
| Land index[6] | − 0.8 | −1.2 |
| Consumer Price Index[7] | + 9.5 | +1.9 |
| Construction materials index[7] | + 4.7 | −0.2 |
| Producer Price Index[7] | + 6.4 | 0 |

Source: [illegible] Home Loan Bank Board; 2. Bureau of the Census [illegible]; 3. Federal Housing Administration; 4. National Association of Realtors; 5. Homer Hoyt Institute [illegible]; 6. Homer Hoyt Institute Land Price Index; 7. Bureau of Labor Statistics [illegible]

This month's **Land Review** examines the mounting evidence of price changes resulted from record interest rates, overall recession and the slump in housing.

Most of the data does not include all of the price concessions offered by sellers eager to dispose of their inventories: price cutting, giveaways, paying the buyer's closing expenses, as well as widespread buy down mortgages for the prospective buyer. These concessions are estimated to cost the seller between 6 and 10 percent of the sales price. If we include these costs, deflation would be considerably higher than our data indicate.

In some cases, concessions do produce sales. "Reducing prices rather than buying down mortgages seems to be producing some results," said a builder from Hillsborough Court, Florida.

But another builder from Wisconsin had a different opinion: "We own 300 lots and can't even sell them at discount prices."

A builder from Clermont County, Ohio wrote, "Inventory situation is a disaster, it is possible to sell houses at 50 cents on a dollar, but even that will not move the inventory much. I don't know what the depression of the thirties was like, but it could not have been any worse."

(Continued on Page 6)

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## Housing Prices

(Continued From Page 1)

There are several ways to measure trends in home prices. One way is to examine the cost per square foot. Another is to use the Bureau of Census' Price Index of New One Family Houses Sold. Less acceptable methods use median or average prices. Probably the most useful, and most accurate, is the cost per squar foot measurement.

The FHA reports that, in 1981, the cost of existing homes sold under FHA section 203(b) program increased 1 percent (third quarter 1980 to third quarter 1981). This is a dramatic change from the increases in the two previous years: 16.2 percent in 1980 and 13 percent in 1979. The cost per square foot of new homes built under the same program in the same period increased only 5.1 percent. This compares to a 15.5 percent increase in new houses in 1980 and an 18 percent increase in 1979. The 1981 figure is the lowest rate of increase per square foot since 1973, when the cost of new homes built under the FHA section 203(b) program increased 4.6 percent.

The Price Index of New Family Houses Sold in 1981 rose 8.0 percent, down from 11 percent in 1980 and considerably below the 14.2 percent rate of 1979 or the 14.5 percent rate of 1978.

The major problems with this index is that it ignores the price market in the recession years of 1980 and 1981. It does not consider the buy-downs and all of the other concessions that are being made in the marketplace in order to sell homes. Many builders are selling homes below what they cost simply to get rid of them. For example, the U.S. Homes Corporation reported selling homes—as well as land—at as much as 15 percent below cost. But not all can do that. "Developers are going bankrupt one after another. No one in his right mind will enter the development business in this area aga... said a developer from Michigan.

Another builder from West Virginia added: "After building 1,000 houses in the past 10 years, we are giving serious consideration to leaving home building ... Reagan Administration is an unmitigated disaster for builders."

## Land Costs

According to the Homer Hoyt Institute land cost data, the rate of increase in the cost per square foot of finished residential lots in 1981 was 5.7 percent, well below the 10.5 percent rate in 1980 and the average 8.5 percent increase between 1978 and 1981. Yearly increases were: 1978, 8.8 percent; 1979, 9.1 percent; 1980, 10.5 percent and 1981, 5.7 percent.

The 1981 increase of 5.7 percent is 3.3 percent below that year's inflation rate of 9 percent. In only 13 states last year did land prices increase more than inflation. In 1981, 29 states showed an increase in lot prices, 20 declined, and one remained unchanged.

In contrast, in 1980 only four states showed a decline: Montana, −1.9 percent; North Carolina, −2.1 percent; South Carolina, −4.7 percent and West Virginia, 8.1 percent and one state, Alabama, was unchanged. The current softening in land prices is the result of record interest rates.

A builder from West Virginia wrote: "Virtually no money is available at any price. We have laid off 80 percent of our production workers, almost all of them remain unemployed."

**States showing a decline in lot prices in 1981.**

| | | | |
|---|---|---|---|
| Alabama | − 1.8% | North Carolina | − 6.4% |
| Arizona | − 6.3 | North Dakota | − 40.7 |
| Hawaii | − 26.1 | Ohio | − 2.5 |
| Illinois | − 3.3 | Rhode Island | − 31.0 |
| Iowa | − 1.0 | South Dakota | − 4.8 |
| Louisiana | − 5.3 | Tennessee | − 27.9 |
| Maryland | − 4.7 | Utah | − 6.9 |
| Michigan | − 27.1 | Vermont | − 24.3 |
| Mississippi | − 5.5 | Virginia | − 11.3 |
| Nebraska | − 5.3 | Wyoming | − 2.8 |

Washington, D.C., Hawaii, California, and Alaska lead in land costs. In general, the North Eastern and Southern states (plus North Dakota) have the lowest land costs. The average for the North East is low because of the environmental and zoning restrictions on small lots. (The cost of an acre or two of land in the suburbs-exurbs of Washington, D.C. would be much lower than land in the heart of the city which runs as high as $615 a square foot. (See page 5.)

The Homer Hoyt Institute Land Index also reflects a change in the cost of finished lots in 1981. See Chart, page 1).

**Why are prices of homes and land of such concern?**

Because the housing component of the Consumer Price Index accounts for 44 percent of the index. The major categories under the housing component, with their share of the overall CPI, are: shelter (29.8 percent), fuels and other utilities (6.3 percent), and household furnishings and operations (8.1 percent).

Homeownership accounts for 24 percent of the CPI. It includes the following elements:

| | Homeownership As a Percent of CPI |
|---|---|
| Home purchase | 10.6% |
| Contracted mortgage interest rate | 7.3 |
| Property taxes | 1.8 |
| Property insurance | 0.6 |
| Maintenance and repairs | 3.7 |
| | 24.0% |

Thus, the price of housing strongly influences the rate of inflation. Inflation in turn determines interest rates, including mortgage rates. When home prices moderate, inflation drops and interest rates decline. ■

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**Annual Subscription:** $95 (U.S. and Canada)
$135 (others)

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Mr. SUMICHRAST. Second, you raised the issue of indexing. I think it just has to go. Something has to be done. It doesn't really help anybody.

The CHAIRMAN. I would go on to say that we need a whole trade-off to do away with the indexing we put into the income tax as well a these others.

Mr. SUMICHRAST. Your point is well taken. There's no question you just can't do it.

Third, I forgot to mention a point which is included in my testimony. I believe that the reason we are in this mess is because of the deficits. I spent 3 months on the budget and I perused the document—which was never published because people told me I would probably get shot—and really went through it. I think it should be required reading in high schools. Of course, nobody would take the time to do it, but it's a most incredible document. It's the U.S. budget and what we have done to ourselves trying to solve our problems by spending ourselves into posterity.

The CHAIRMAN. Mr. Sumichrast, Mr. McKinney, and Mr. Schechter, thank you very much for coming today.

The committee is adjourned.

[Whereupon, at 11:25 a.m., the hearing was adjourned.]

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